BANKING PRINCIPLES AND PRACTICE

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IN FIVE VOLUMES

VOLUME IV
DOMESTIC BANKING—EARNING ASSETS

NEW YORK
THE RONALD PRESS COMPANY
1921

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THE DISCOUNT DEPARTMENT

General Functions and Organization of the Discount Department

The discount department has charge of paper discounted for customers of the bank and commercial paper purchased in the open market. This work includes the calculation of discounts, the physical handling and keeping of the paper and attached collateral and the offering sheets, the collection of bills due, the putting through of credits, and the necessary bookkeeping concerned. It includes also the preparation of paper for rediscount with the federal reserve bank or for pledge on collateral with the federal reserve bank or for sale in the open market.

The internal organization of the discount department varies widely, of course, with the banks. The head of the department is known as the "discount clerk." The man at the window meets the customer. At one or more desks a group of clerks may have the care of the offerings, the collateral and substitutions, and the putting through of credit; at another desk the collection of bills each day may be handled; at another the earnings book, tickler, etc., may be kept; and recently the large metropolitan banks have found it expedient to have another group of clerks handle only domestic acceptances. But the work of the discount department, like that of the loan department, is very unevenly distributed through the day; and for this reason the clerks are freely shifted from one of the above groups to another, according to the pressure of work.

The Nature of Discounting

The principle of bank discount is the collection of interest in advance. Such interest is not yet earned. In the case of a loan

the borrower makes his note out with interest at an agreed rate from date, and he receives the face amount of the note and pays the interest at maturity or in monthly or quarterly instalments. But if the note is to be discounted it is made without interest and the borrower receives only the proceeds, that is, the face of the note less the interest on that amount for the time the note is to run. At maturity the face amount is paid and the transaction is closed. But commercial negotiable papers, interest or non-interest bearing, in the hands of the customer, may also be discounted, such papers possibly coming into the possession of the customer in the course of his daily trade or banking business. In any case discount is computed on the face amount (if it is an interest-bearing note the face amount includes principal and interest at the nominal rate for the period of the note) for the period intervening between the dates of discount and maturity, and the proceeds are paid to the borrower.

The practice of discounting offers a slight advantage to the lender in that he collects interest, not on the amount he actually lends, but on the amount he receives at the time the loan is liquidated. For instance, if a borrower discounts his 60-day note for $100,000 at 6 per cent, he receives $99,000; in other words, he pays $1,000 for the use of $99,000, or at the rate of 6.06 per cent per annum, and in an institution which has constantly outstanding a large amount on bills discounted this extra income may amount to a considerable figure. The following table shows the difference in per cent of return per annum between lending money for a year on simple interest and advancing funds by discount of one-year paper.

By Interest	By Discount
1%	1.010101%
2	2.040816
3	3.092783
4	4.166666
5	5.263157

6	6.382968
7	7.526881
8	8.695652
9	9.890109
10	11.111111

While strictly speaking this practice may net the lender a little more than the legal rate of interest, the courts have ruled that it is not usury. It is simply a universal banking custom sanctioned by long usage.

In calculating discount, it is customary in most localities to count the actual number of days the money is borrowed, including the day of maturity but not the day on which the discount is made. It is also customary to figure on the basis of 360 days to the year, another practice which favors the lender, but one which has become established on account of the ease and rapidity with which calculations can be made. Discount clerks find that discount can be figured by hand with much greater speed and accuracy than when a table or someof the ingeniously constructed calculating machines are employed.

The Nature and Care of Discounted Paper

The paper held by the discount department is, with respect to its ownership, of several classes:

1. The notes and acceptances discounted by the bank and now the property of the bank.
2. Bills receivable which have been pledged by banks and other borrowers as security for loans, and which are kept in the department because it has better facilities for caring for them than has the loan department.
3. Time items, the property of customers, which have been deposited or left with the bank for collection and credit to the customers' accounts, when due; in many banks these are held by the note teller, who attends to their collection.

The greater part of the paper held by American banks consists of unsecured and single-name forms. The growth of acceptances has increased the proportion of two-name paper in recent years. Since the great bulk of credit is extended on unsecured loans, it is evident that a close watch must be kept on the credit of all those borrowing on their own unsecured notes or by discounting the unsecured notes of others. Changing conditions must be duly considered, and credit information must be constantly sought and carefully analyzed. This is a function of the credit department.

One of the most exacting duties of the discount clerk is the care of bills receivable pledged with the bank as collateral by bank correspondents. Loans by a reserve city bank to a correspondent bank are made on an unsecured or collateral note, or else by rediscounting commercial paper. The usual way is for the correspondent to give its collateral note and pledge a large number of bills receivable of small denominations. The volume of this business is rapidly declining, for correspondent banks which are members of the federal reserve system are relatively ceasing to borrow from reserve city banks, and instead are borrowing or rediscounting with their federal reserve banks. It is reasonable to assume that this tendency will continue as country banks accustom themselves to business operations with their federal reserve banks.

Each bank's receivables are kept by the discount department in a separate envelope, which is ruled to show the amount and maturity of the loans, the amount of collateral received and returned, with the dates, and the balance of collateral on hand. In this way can be told at a glance to what extent any correspondent is indebted to the bank and whether a proper margin is being maintained. The receivables are kept arranged in the order of their due dates, and all are entered on cards arranged chronologically showing just what notes fall due on any particular date.

Rediscounting of Bills Receivable

When the borrowing by a correspondent is done by rediscounting bills receivable taken from the correspondent's portfolio, these notes are usually payable at the office of the sending bank and of course bear that bank's indorsement. They are accepted with the understanding generally that they are to be forwarded to the borrowing bank for collection and are to be charged to the bank's account on the day of maturity. A peculiar sentiment has pervaded the American banking and business world against rediscounting; country banks have hesitated to sell their discounts lest their customers interpret it as due to financial weakness. Frequently when they do rediscount they take precautions to keep their customers from knowing that their paper has been rediscounted; one way of doing this is to indorse their bills rediscounted with pencil and request the buying bank not to place its stamp or collection number upon them. All such requests are carefully complied with by the reserve city bank. A small slip of paper is attached to each one of these notes, and the collection number is stamped upon the slip; in this way the items may be readily identified, and at the same time the notes are not mutilated as the slips can be easily detached. Another arrangement to the same end is to buy the paper with an agreement to resell it again to the seller if specified conditions are met.

The practice of rediscounting has not been encouraged by the reserve city banks. It is much more satisfactory, from their point of view, to lend on the bank's own collateral note, for several reasons:

1. A margin of collateral is required, and this adds to the safety of the loan.
2. A special form of collateral note may be used which clothes the loaning bank with certain important privileges that it would not otherwise enjoy.

3. This method entails much less clerical work than does rediscounting and there is, therefore, the added advantage of time saved and possibility of error minimized.

Since there is a reluctance to rediscount on the part both of the country selling banks and of the buying reserve city banks, loan operations between these two classes of banks have generally been by collateral note instead of rediscounts; and this inveterate practice helps to explain the tardy growth of rediscounting with the federal reserve banks.

Guaranties in Lieu of Indorsement

All guaranties on loans or discounts are in the custody of this department. They are taken in lieu of indorsements, and the effect is practically the same as that of an indorsement, namely, the effect of an additional security on the paper covered by them. In many cases a borrowing firm wishes to give the bank a personal indorsement on its paper, but it is not convenient for the indorser to be present at all times when bills payable are to be issued; or there may be several persons each living in a different city and all wishing to indorse, and in such an instance all paper issued would have to be sent around from one to another, which would involve risk, inconvenience, and loss of time. To meet such exigencies the method of guaranty was devised. The instruments are of various kinds, some continuing in force until written notice of their revocation has been received, some running for a certain specified time and void after a certain date, and still others of a specific nature covering only a particular note or series of notes. Usually they state the maximum amount for which the guaranty shall be in force.

Responsibility of Directors for Approval of Discounts

The making of discounts is an inalienable function of the directors of the bank. It is exclusive and cannot be delegated to any officers.

> [The board may empower an officer or officers] by a single resolution to make a considerable number of discounts or loans, provided they be requested; but this resolution must name the person or persons to whom the loan may be made, the aggregate sum which they must never exceed, the time, and such other particulars as the directors may deem of moment. Thus in fact though many separate notes may be authorized by this one vote, yet nothing is really done beyond the supervision of the directors, or without the active exercise of their discretion. They may order the cashier to let A have such loans as he shall wish, in such sums and at such times as he shall ask, within a certain period, up to the amount of a designated sum, to run for specified times, at rates of interest named, and upon designated conditions concerning indorsers or collateral security. This does not leave each individual discount made to A to be passed upon by the directors; yet in fact no discount is made to him by any official authority other than that of the board, or at the substantial discretion of any person save the directors.[1]

This being the law, it becomes a serious problem in a very large bank to have the applications for loans and discount passed upon by the directors themselves; the volume of such applications is large, and the directors are active business men engaged in other lines and only incidentally bank directors, and they cannot sacrifice the time necessary to scrutinize each particular application when it comes up. The directors have weekly or monthly meetings; they cannot be in session continuously. They have several devices for controlling loans and discounts and guarding their responsibility. One is the granting of "lines of credit" for loans and discounts, as indicated in the above quotation from Morse. A second is the use of a discount committee, composed of a few of their number and of officers, who pass upon the applications as they come up and bring their approvals to the weekly directors' meeting for final sanction; this committee is clothed with such great responsibility that it is composed of men who are the shrewdest at hand and who give all or nearly all their time

[1] Morse, pp. 249–250.

to the bank's affairs. A third device is to allocate all loan and discount applications arising from a certain area or kind of business to a vice-president or other high officer who, acting alone or as a member of the discount committee, passes upon the applications as they arise, within limitations set by the directors, and these are approved later at the directors' meeting. The treatment described below is a composite of these methods.

Routine of Department's Work

It is the business of the discount department to prepare the offerings in such form and detail as will expedite the examination and decision of the directors. For each offering received for discount an offering ticket must be filled in and sent to the proper officer. These tickets show the amount applied for and the time the loan is to run, with indorsers, guarantors, or collateral, if any; the amount already under discount, with maturities and rates; the highest amount under discount at any time during the preceding year; similar information from the loan department; the amount with the foreign division; the average balance for the preceding six months; the average balance for the corresponding months of the year previous; and the actual balance on the day in question. They also show when and for how long the applicant was last out of debt to the bank, what officers have authority to negotiate loans, whether interest is paid on daily balances, and, in the case of banks, the capital and surplus.

The offerings are then passed upon by the officers. If an offering is approved, the rate is marked on the ticket and the ticket is initialed by, say, three officers. Later in the day the broker delivers the paper, accompanied by his bill, which is similar in form to the discount statements mentioned above. The bill is checked, and if found correct a cashier's check for the amount of the proceeds is issued to the order of the broker making the sale.

At the close of business each day all offering tickets and

brokers' slips are checked by the discount clerk against the paper received, to be certain that they correspond in every respect. He then initials the tickets and slips and forwards them to the credit department, where they are filed as a part of the permanent records.

Each morning the discount clerk sends to the cashier a detailed statement of the preceding day's accepted discounts. This shows the name, business, and location of the borrower, with the amount, rate, and maturity of the offering, the total amount under discount for each customer, the total of the day's business, and the amount of discount collected. Such statement gives the cashier a synthetic knowledge of the discount operations of the bank from day to day.

The discount clerk also sends to the regular directors' meeting a statement of the discounts since the last meeting, showing name, location, and business of each borrower, the amount borrowed, and the total amount under discount; and in the case of purchased paper the commercial rating of the maker is given. He certifies over his signature to the completeness and accuracy of this statement.

The discounts, returned from the directors' meeting, are checked off in the tickler and filed away in the order of their maturities, those payable in the home city in one box and those payable out of town in another. The latter are forwarded for collection about ten days before maturity, by the country collection clerk, who makes the proper credit to Bills Discounted on the day the notes are due. Paper payable at the bank itself is tendered each morning to the bookkeepers, who hold the proper amount against each note and initial the notes. Some firms send checks in payment of their maturing paper; in such case the obligations are canceled and returned to them at once. For the most part, however, the notes themselves are used as vouchers, are charged against the several accounts, and are returned at the end of the month in the ordinary course of business.

Advances and Rediscounts with the Federal Reserve Bank

The function of preparing: (1) discounts for rediscount with the federal reserve bank, and (2) discounts or other collateral for pledge with the federal reserve bank for advances, is lodged with the discount department.

All such paper must be indorsed in blank by an officer of the member bank whose signature and authority to indorse have been filed with the federal reserve bank. The items are listed on application forms prescribed by the reserve bank. On it the member bank officer certifies that to the best of his knowledge and belief the original loans which are evidenced by the notes or acceptances listed below were made for agricultural, industrial, or commercial purposes, and are eligible for rediscount with the federal reserve bank, under regulation of the Federal Reserve Board. The application form requires the following description of each item: the maker's name, address, and business; the indorsers; the amount; maturity date; whether it was discounted for a depositor or purchased; and the date of the last statement of the borrower on file on items of $5,000 or over. The application form for member state banks and trust companies contains an additional declaration that the discounts applied for conform and will conform to the provisions of the Federal Reserve Act, forbidding discounts for state banks and trust companies of notes, drafts, or bills of exchange of any one borrower liable for borrowed money in excess of 10 per cent of the bank's capital and surplus.

In case the application is for an advance of funds, the cashier of the borrowing bank executes a collateral note in favor of the federal reserve bank, pledging notes, drafts, bills of exchange, or bankers' acceptances, or bonds or notes of the United States, as described in the schedule included in the application for the loan. The list form is similar to that required from applicants for rediscounts and requires the same description of the pledged items. If securities of the United States are to be pledged, a different

form is used. By the terms of the note the federal reserve bank is given the right to require such additional security as it may deem proper, and, in case of default in providing the additional security or in case of non-payment of the note, is also given the right to sell the collateral in whole or part.

The paper eligible for collateral for such loans, or for rediscount with the federal reserve banks, is defined by the Federal Reserve Board, and the same rules of eligibility apply for each of these uses. To facilitate the flotation and banking operations connected with the Liberty Loans, the federal reserve banks, for advances not exceeding fifteen days, established preferential rates of discount "for notes, drafts, or bills of exchange issued or drawn for the purpose of buying or carrying bonds, notes or certificates of indebtedness of the United States, and secured thereby, having a maturity at time of discount of not more than 90 days"; and "for one-day promissory notes of member banks required in connection with transactions involving the fiscal operations of the Government, secured by eligible paper or bonds, notes or certificates of indebtedness of the United States." It has also been the policy of the federal reserve banks to grant preferential rates to acceptances.

Proper notations must be made on the bank's books against all paper so hypothecated with the federal reserve bank, and from time to time early maturing notes must be withdrawn and approved substitutions deposited. The credit man of the federal reserve bank may pass unfavorably upon certain of the paper tendered for discount or collateral and may insist upon other paper or upon further credit information about the objectionable paper, in which case other paper or additional information must be provided by the discount clerk. Paper pledged with the federal reserve bank is returned to the pledging bank when substitutions are provided. Paper discounted by the federal reserve bank is sent for collection somewhat in advance of maturity to the bank where payable.

Records in the Discount Department

There are various books used in the discount department, some of which are very essential and are found in this department in every bank; others may be peculiar to a bank and be kept primarily because of its peculiar organization or because of the character or methods of its business. Some of the more common books are the route book, the yield book, the liability ledgers, the discount ticklers, the offering book, the maturity books, and the bills receivable book.

1. *The Route Book.* At the opening of business each day the clerks enter in the route book from the discount tickler the notes due that day and payable within the bank's city collection limits, and indicate the place of payment on each item. The total amount of this book is deducted from the total of the discount tickler page, and the balance must prove against the figures of the country collection department, which is collecting the other notes. After this proof is made, these items are sent out for collection by messengers; as each messenger reports on his items they are checked off on his route sheet.

2. *The Yield Book.* This book shows the exact amount of the bills discounted under the various rates and the amount each is earning daily, and also the average rate. For purpose of illustration, suppose the bank had under discount bills running at the following rates:

$ 6,000,000	at	6 %	yield	per	day	$1,000.00
14,000,000	"	5½	"	"	"	2,138.89
12,000,000	"	5	"	"	"	1,666.67
8,000,000	"	4½	"	"	"	1,000.00
10,000,000	"	4	"	"	"	1,111.11

making in all $50,000,000 earning $6,916.67 a day, at an average rate of 4.98 per cent; and suppose at the close of business the following changes have occurred:

On: Amount Loaned		Off: Amount Maturing	
$10,000	at 6%	$ 6,000	at 6%
20,000	" 5	10,000	" 5
18,000	" 4	4,000	" 4
$48,000		$20,000	

making a net increase of $28,000 for the day, with an increase in earnings of $3.89. In summary: total amount of bills discounted $50,028,000, earning per day $6,920.56, or at the average rate 4.98 per cent.

3. *The Liability Ledgers.* These contain alphabetical lists of borrowers, one or more ledgers for individual customers and one or more for bank customers. By means of these books the bank is able to tell what are the liabilities of its customers to the bank as discounters or borrowers and as indorsers for others. A man may not be a heavy borrower himself, but he may have indorsed for others to such an extent as seriously to impair his credit. Borrowers are generally given a line of credit based upon what their accounts with the bank and their general credit would seem to warrant. To keep the run of this line of credit is one of the particular uses of the liability ledger, for it is contrary to the National Banking Act for a bank to loan to any individual or firm upon his or their own name more than a certain per cent of the capital and surplus. In a large and active bank it is impossible to keep track of these loans without the use of the liability ledger. All items are entered as follows: date when the loan was made; rate; maker; indorsers, if any; amount; and maturity.

4. *Discount Ticklers.* The ticklers cover a period of one year, and one tickler is assigned, say, to each month. Two or three pages, depending upon the volume of business, are devoted to a day, each page having columns as follows: For whom discounted; rate; maker; amount; whether individual, bank, purchased, or acceptances; and where payable. Country items are usually sent for collection about ten days before maturity, and a receipt

for all such items is given by the country collection department. When paid in advance, a note is at once transferred from its regular due date to that upon which it is paid and a memorandum made in the proper columns of the discount ticklers and the discount ledger. Similar action is taken in case a past-due note is paid. If partial payment is made, only the amount so paid is entered in the column and is brought forward under the day of payment.

A separate tickler may be kept for acceptances, with columns to distinguish acceptances of the bank and of other banks.

5. *The Offering Book.* In this book is entered a full description of the paper. It gives a complete history of the offering and must be correct in every detail. The offerings are arranged alphabetically as to individuals, banks, and purchased paper names, and are entered as follows: for whom discounted; indorsers, if any; total amount of offering; rate; maker; number of days to run; due date; amount; discount; exchange; and where payable. When all notes have been entered, the gross amount of offerings is footed, and also the total amount of discount, and these two items are proved against the ticket by which Bills Discounted are charged and Discount account credited. The book is ruled off weekly (if the directors meet weekly), and the week's total amount of bills discounted and of discount, together with all notes discounted, are sent to the directors' meeting.

6. *Maturity Books.* It is the purpose of these books to show at a glance the maturity of all paper discounted by the bank. They are for the use of the officers. At the close of business each day all notes paid are marked off and all notes discounted entered.

7. *The Bills Receivable Book.* In this book is kept a re ord of all bills receivable held as collateral to notes discounted or received by the loan department. These bills are entered under their respective due dates, and there are also recorded the dates when the notes were received, from whom, the maker, and the

amount. Should any of these pledged bills fall due before the maturity of the borrower's collateral note, they must be sent for collection a few days before they mature, and care must be taken that sufficient other notes are received in substitution to maintain the proper margin of collateral.

CHAPTER XLIII

THE LOAN DEPARTMENT—LOANS TO STOCK BROKERS

General Functions of the Loan Department

It is the function of the loan department to make the loans of the bank and to take care of the collateral securities pledged, as some loans are secured by pledge of collateral. The specialization of a department is required for handling collateral loans alone, where their volume is large, a condition which prevails in the vicinity of the stock and commodity exchanges and in the reserve cities, whose banks loan heavily to out-of-town banks and individuals on collateral notes.

The collateral tendered varies widely with the location of the bank and its clientele. It usually consists of corporate bonds and stock certificates. In this form it constitutes a very large proportion of the hypothecated instruments in Wall Street banks which facilitate stock exchange transactions. Another form quite common in the case of loans to correspondent banks is bills receivable—the discount paper of their local customers. Advances are also made on warehouse receipts covering sugar, cotton, coffee, lead, copper, corn, wheat, and other staple commodities; banks which are located in the receiving and storage centers for these produce or metal exchanges and which cater to certain of these trades naturally loan heavily on pledged warehouse receipts, elevator receipts, cotton tickets, etc.

The values of the pledged bonds, stocks, and receipts are determined largely on the organized and "curb" speculative exchanges, and it is necessary that the loan department guard itself in the light of price fluctuations there. To be on the safe side, a certain percentage of margin in excess of the face value

of the loan must be asked at first, and then maintained by the required tender of additional collateral in the case of a slump in values; withdrawals may be allowed later when quotations advance. Moreover, during the life of the loan, substitutions of collateral are allowed, made in securities of equal market value and desirability. In the acceptance of substitutions great care must be taken, for, while the collateral offered for exchange may be of equal market value and desirability, the quality may be lower.

As custodian of the collateral held by the bank to secure its loans, besides the safe and orderly keeping of the collateral, certain incidental duties devolve upon the loan department, such as the detachment and delivery of coupons upon the request of the borrower, or crediting them when collected to his account, the confirmation or correction of comparisons as often as the borrower renders the same, and the maintenance of a permanent record and description of incoming and outgoing collateral, closely correlated in each instance to its particular loan.

The loan department proves the computation of interest paid on loans, and prepares lists of proper credits for principal and interest. Statements are rendered periodically on loans made, being prepared more frequently on brokers' demand loans than on time loans or on depositors' demand loans. The rates on the demand loans are raised and lowered as the money market fluctuates, and the borrower is notified in each instance. The department also keeps a record of the daily, monthly, and yearly average rates on time and demand loans, brokers' balances, day loans, demand loans, bank loans, etc., and prepares for the directors' meetings reports of all loans made and remaining unpaid.

Internal Organization

The volume of work for the department as a whole, and for the different divisions of the department, fluctuates widely during the day. A slump on the exchange not only suddenly and

immensely increases the volume of loans demanded, but particularly affects the margin clerk. On the other hand, an upward swing of exchange prices, while increasing the volume of loans to facilitate the greater volume of exchange transactions, leaves the margin clerk at ease. A bulge in the price of one or more securities may induce the owner to sell his holdings, part of which may be pledged for loans at his bank; such a sale will force collateral substitutions in unusual amounts and crowd the substitution clerk. Certain other lines of activity, like the care of the interest book, the preparation of statistics, etc., are of more even tenor and less peremptory in their demands.

These fluctuations in the volume and allocation of the department's work react upon its internal organization. It becomes necessary to concentrate the clerical force in accordance with the pressure of work. The clerks do almost any task within the department; while each may be given certain responsibilities, as the care of the daily earnings book or the care of margins, he in addition stands ready to shift at any time to some other pressed station. The department is administered by the loan clerk, or "brokers' cashier," as he is sometimes called; the windowmen are specialized for obvious reasons; but the other groups of clerks, those handling the margins and collateral and those doing the bookkeeping, are general utility men. Working under or cooperating with the loan clerk is a regular broker on the exchange in the "money crowd."

Classification of Loans of Banks in the United States

The classification of loans and discounts of the national banks of the United States and of New York City is shown in the accompanying table. It will be observed that about one-fifth of the loans of the United States are on demand and three-fourths on time, that a larger per cent in New York are on demand, due almost entirely to the proportion of loans secured by stocks and bonds, and that the loans with real estate security are negligible.

Classification of Loans and Discounts of the National Banks as of June 30, 1920

Class	All United States Amount (In millions)	All United States %	New York City Amount (In millions)	New York City %
On demand, paper with one or more individual or firm names (not secured by collateral)....	$ 707	5.20	$ 33	1.20
On demand, secured by stocks and bonds..................	1,261	9.27	355	12.93
On demand, secured by other personal securities, including merchandise, warehouse receipts, etc........................	392	2.88	88	3.13
	$ 2,361	17.35	$ 476	17.24
On time, paper with one or more individual or firm names (not secured by collateral).........	$ 7,604	55.87	$1,590	59.00
On time, secured by stocks and bonds......................	1,855	13.64	429	15.23
On time, secured by other personal securities, including merchandise, warehouse receipts, etc........................	1,390	10.21	188	6.85
	$10,849	79.73	$2,208	81.08
Secured by real estate mortgages or other liens on realty not in accordance with Section 24, Federal Reserve Act, as amended....................	$ 93	0.69	$2	0.07
Secured by improved real estate under authority of Section 24, Federal Reserve Act, as amended....................	135	1.00		
	$ 228	1.69		

Classification of Loans and Discounts of the National Banks as of June 30, 1920—(*Continued*)

Class	All United States		New York City	
	Amount (In millions)	%	Amount (In millions)	%
Acceptances of other banks discounted	$ 146	1.08	$ 51	1.86
Acceptances of this bank purchased or discounted	22	0.16	5	0.16
	$ 168	1.25	$ 56	2.09
Grand Total	$13,611	100.00	2,744	100.00

Another classification may be made on the basis of the personnel of the borrowers.

Classification of Loans (Including Paper Bought) Made by 600 National Banks in all Reserve and Other Cities having a Population of over 50,000, as of December 31, 1918

Direct and indirect loans made to banks	$ 474 million
Direct loans to individuals, etc., who keep deposit	4,682
Direct loans to individuals, etc., who keep no deposit	1,241
Securities, etc., purchased from banks with agreement to resell	12
Other loans, including foreign loans	76
Total loans	$6,485
Loans placed for account of correspondents:	
For national banks in reserve and central reserve cities	52
For national banks outside of reserve and central reserve cities	69
For state banks and trust companies	166
Total	$ 287

It will be observed that at this date four-fifths of the loans were made to depositors; a good proportion of the deposits in fact arises from loan operations. The classification shows that reserve city banks place loans for their correspondents, both national and state institutions.

Classification of Collateral Loans

1. Merchandise Loans. These are payable on demand, and are secured by warehouse receipts and bills of lading representing commodities of various kinds.

2. Time Loans. These are payable at a specified time, are made to banks, brokers, firms, or persons, and are secured by stocks, bonds, and bills receivable. They are not subject to call until the expiration of a certain number of days. The tendency is to shorten the period of time loans and to quote it in days rather than months. Brokers and other borrowers seek to arrange matters so that a certain proportion of their borrowings shall be on time, but banks prefer to loan on call and thus enjoy a higher liquidity of assets. On this account call loans, except in times of great stringency, command a lower rate of interest.

3. Special Loans. Special loans are payable on demand and they are made to individuals who keep accounts with the bank, to officers of banks which keep accounts with the bank, who borrow for their personal use, and to banks which keep accounts with the bank, borrowing on their demand notes secured by stocks and bonds or on bills receivable. Included in this class are also other loans made under special agreement and payable on demand. The special loans are seldom called, and when they are it is not with the expectation of receiving payment at once.

4. Demand Loans, or strictly Street Loans.

5. Brokers' Special Loans.

The bank may also act as agent for many of its customers, loaning in the metropolitan market any excess money they have.

In such cases the bank generally handles the funds as if they were its own and informs the customers that it will give the same care to loans made for their account as it does for its own, but that beyond that it assumes no responsibility. The customer is advised by the bank of the amount and rate of each loan and is furnished with a list of collateral, all substitutions and changes of rates being reported the day they are made.

Stock Brokers' Loans

Loans to brokers have been classified above into time, demand, and special loans.

The demand loans are those made by the bank to brokers who keep no account with the bank. They are strictly demand loans, and the bank does not hesitate to call them whenever the need arises. The makers have no claim on the bank and understand perfectly that when money stiffens or the market has a sudden break, demand loans are those which the bank will call first. Some banks make a practice of calling all their loans every day; others do not call unless they have pressing need for the money. The broker knows by experience which banks call and which do not, and can to some extent guard against the emergency, but not always. The demand loans constitute one of the very quick assets of the bank, and it tries to have large amounts of these loans at all times. "Brokers' specials" comprise loans to brokers who do keep accounts with the bank. These are also quick call loans, but on account of business relations the bank does not call them until the demand loans are all closed out, unless it wishes to reduce a line that is exceptionally large. It happens quite frequently that they are not called for years, even for a decade or more. Both demand loans and brokers' specials are secured by stocks and bonds listed on the stock exchange.

The common form used in calling a loan is as follows:

.... Bank of New York
New York, ...(date)

Mr.............(broker),
........................(address)

Dear Sir:

Please send check for $....... (sum), loan dated .... (date), and oblige

Yours respectfully,
......................(name)
Cashier.

Although call loans to brokers are made subject to repayment on demand, it is the custom of Wall Street to consider them as loans for a day; that is, those made today are not in practice subject to call until the next day. Calls are made, by custom and rule of the Street, in the morning and not later than 1 P.M., and the broker is allowed until 2:15 to make payment and recover his hypothecated securities. If, however, after 1 o'clock the bank learns something which it does not like about a firm, it can legally call the loans up to 3 P.M. or the close of business.

Call loans to brokers are the most active loans made by the bank and are continually changing both as to rate and collateral. The rates follow those made on the exchange during the day and in active times change very often. For instance, take the figures reported for September 19, 1919, of the amount of call money placed on the floor of the New York Stock Exchange:

$27,700,000	at	6%	
600,000	"	7	
1,100,000	"	8	
5,700,000	"	9	
1,500,000	"	10	
1,500,000	"	12	(after the close of the market)
400,000	"	15	" " " " " "

The collateral deposited as security consists largely of the stocks and bonds which the broker borrowing the money is carrying on margin for customers, and whenever his customers sell

any of these the broker withdraws those sold and substitutes others. The collateral of a broker sometimes completely changes within a few days.

Method of Placing Loans

The loaning of money to brokers is accomplished both by direct contact with the borrower and through the agency of money-brokers, who act as middlemen between the lender and the borrower. A large part of the loans is made by the money-broker on the exchange, and the rate for call money is established there. There was formerly on the New York Stock Exchange a regular place, the "money post," in the boardroom, for effecting loans, and the money-brokers, the "money crowd," congregated there. The exchange in 1919 adopted the scheme of a "money table," presided over by a loan expert, who handles the business under the general supervision of a special money committee composed of members of the exchange. To this table each broker submits a memorandum of his money needs, and when loan money comes it is allocated among applicant brokers; the purpose of this arrangement is to eliminate spasmodic or feverish bidding for loans at different times during the day.

There are some brokers who make the loaning of money their exclusive business. The money-brokers make the loans for banks, private bankers, some mercantile firms, railroad and insurance companies, and some wealthy individuals. The broker who acts in this way as agent for some bank or banks in lending call money may perform the service gratuitously, hoping thereby to establish himself with the bank and assure himself of banking connections. Some banks pay their brokers an annual salary; in other cases the brokers act for a small per cent brokerage, but there is no recognized commission for the loaning of call money. In the case of time loans the brokerage can be and is added to the charge to the borrowers. A large bank may have its own private broker, who does nothing else than place its loans on the board.

On the receipt of the morning figures from the clearing house, the bank's loan policy for the day is determined; if there is a good balance and it is known that no large drafts are to be presented that day, the bank instructs its broker as to the amount which he may loan, and the rates thereon.

Collateral for Loans

As the broker places the loans, he notifies the bank of the name of the borrower, the amount loaned, and the rate. All the collateral is subject, of course, to the bank's approval, and as the securities offered constitute the bank's best protection in this matter they are scrutinized very closely. When the loan is presented at the window, reference is had to the contract made by the bank's money-broker to see that the amount and rate are correct. The securities are then counted and checked with the list given on the envelope in which they are enclosed, and they are carefully examined. The precaution taken is to see that all collateral offered is a strictly "good delivery" according to the rules of the stock exchange, thereby assuring a regularly organized and ready market for immediate liquidation and also protecting the bank against the contingency of being unable to liquidate the collateral in case the company whose securities compose the collateral has temporarily closed its books for some business reason and made transfers impossible.

The broker tenders his collateral in an envelope (Figure 33) on which is written his name and the securities contained therein, with their amounts. The face of this loan envelope appears as shown on page 838.

The date, page, and number are added by the bank. After the loan department satisfies itself regarding the collateral the borrower is given either a check or a credit on his account, together with an engraved identification certificate bearing, say, a number and letters which correspond with the figures when a certain key is used. These identification slips must be returned

signed by the firm, when the loan is paid. The key system is employed to make difficult the forging of these certificates; since a stock exchange firm uses so many messengers, the danger of

Received *(Date)*

No.______ Page______

The Property of

(Broker's name)

Securities

150	*Pa. R. R.*	*5,000*
699	*N. Y. C. & H. R. R.*	*45,000*
100	*Western Union*	*8,000*

Figure 33. Loan Envelope for Securities (face)

delivering securities to unauthorized messengers would, without the keyed identification certificate, be great. After a transcript of its face has been taken, the broker's envelope of securities is filed. No evidence whatever of a loan appears on this envelope;

it is simply a deposit of securities. The bank makes out a card for its own files describing the transaction. This peculiar use of a loan envelope descriptive of the collateral but not of the loan was established years ago to obviate war stamp taxes on securities deposited as collateral and also to expedite this form of loan; the trouble and time consumed in writing a special collateral note for each loan of this kind would make it quite impossible to handle the many loans now handled in the brief space of time between two and three o'clock in the afternoon.

The Loan Agreement

All brokers and others borrowing money on collateral must sign a note or a form of agreement. In most cases an agreement is used; if the loan is on time a note is used. The note and agreement forms are somewhat similar, both giving the lending bank authority in case of default to use the securities pledged as collateral to clean up the indebtedness. They also authorize the bank to sell and use the proceeds of any other securities of the borrower held by the bank, and give it a lien on whatever balance the borrower may have as a credit deposit in the bank. The following is an abridgment of the typical agreement:

Know all men by these Presents, That the undersigned, in consideration of financial accommodations given, or to be given, or continued to the undersigned by the .... Bank, hereby agree with the said Bank that whenever the undersigned shall become or remain indebted to the said Bank for money lent, or for money paid for the use or account of the undersigned, or for any overdraft or upon any indorsement, draft, guarantee, or in any other manner whatsoever, the said Bank shall then and thereafter have the following rights, in addition to those created by the circumstances from which such indebtedness may arise against the undersigned, namely:

1. All securities deposited by the undersigned with said Bank, as collateral to any such loan or indebtedness of the undersigned

to said Bank, shall also be held by said Bank as security for any other liability of the undersigned to said Bank, whether then existing or thereafter contracted; and said Bank shall also have a lien upon any balance of deposit account of the undersigned with said Bank, existing from time to time, and upon all property of the undersigned of every description left with said Bank for safekeeping or otherwise, or coming to the hands of the Bank in any way, as security for any liability of the undersigned to said Bank now existing or hereafter contracted.

2. Said Bank shall at all times have the right to require from the undersigned that there shall be lodged with said Bank as security for all existing liabilities of the undersigned to said Bank, approved collateral securities to an amount satisfactory to said Bank; and upon the failure of the undersigned at all times to keep a margin of securities satisfactory to said Bank, or upon any failure in business or making of an insolvent assignment by the undersigned, then and in either event all liabilities of the undersigned, to said Bank, shall at the option of said Bank become immediately due and payable, notwithstanding any credit or time allowed to the undersigned by any instrument evidencing any of the said liabilities.

3. Upon the failure of the undersigned either to pay any indebtedness to said Bank when becoming or made due, or to keep up the margin of collateral securities above provided for, then and in either event said Bank may immediately without advertisement, and without notice to the undersigned, sell any of the securities held by it as against any or all of the liabilities of the undersigned, at private sale or Brokers' Board or otherwise, and apply the proceeds of such sale as far as needed toward the payment of any or all of such liabilities, together with interest and expenses of sale, holding the undersigned responsible for any deficiency remaining unpaid after such application. If any such sale be at Brokers' Board or at public auction, said Bank may itself be a purchaser at such sale free from any right or equity of redemption of the undersigned, such right and equity being hereby expressly waived and released. Upon default as aforesaid, said Bank may also apply toward the payment of the said liabilities all balances of any deposit account of the undersigned with said Bank then existing.

It is further agreed that these presents constitute a continuing agreement, applying to any and all future as well as existing transactions between the undersigned and said Bank.

Dated, New York, the ...... day of ......, 19... ....
..............(Signed)

It is to be noted that this agreement is very sweeping in the security it provides for the bank; that it contains no mention of any specific loan or maximum amount of loan, or of rates or terms, but is wholly ancillary to other loan contracts; and that it is a continuing contract.

Day Loans and Overcertification

In this connection a statement of the nature of "clearance loans," or "day loans," is fitting. Until within the last decade the custom of the Street was for a bank to agree to certify checks to the amount, say, of $1,000,000 for a broker who would carry with it an average cash balance of, say, $100,000. Certification meant that the bank assumed the obligation to pay the check on presentation over the counter or through the clearing house, the implication being that the broker had at least $1,000,000 balance at the bank, out of which it would set aside funds to the amount of the face value of the checks certified. But the practice was one of overcertification, for the balances were much less than the certifications signified. Overcertification was forbidden by the National Bank Act, but its one-time almost universal practice in Wall Street shows that this feature of the act was a dead letter. The Comptrollers of the Currency opposed overcertification, and the banks gradually adopted a system of "day loans" in order to meet the requirements of the law. In the morning the broker estimates his probable needs for certification that day, and on the basis of his single-name unsecured note borrows enough to provide him with sufficient credit at the bank to cover what checks he expects to present for certification during the day. Plainly, while this loan system obviates technical overcertification, it has

exactly the same practical result, for the banks still make the same extensions of credit on the same scant security.

Some of the Wall Street banks have taken a more conservative attitude toward "clearance," or day loans, by demanding collateral to secure them. The adoption of this rule naturally caused a rapid decline in the number of brokers' accounts and in the amount of their balances with conservative banks, and diverted such accounts to less conservative institutions.

Day Loan Agreement

For the clearance loan, with the security deposited, the broker is required to sign some such form letter as follows:

New York, N. Y., ... (date)

The .... Bank of New York,
New York City.

Dear Sirs:

For the purpose of securing to you the payment of any and all clearance loans which you may hereafter make to us, we deliver to you herewith and pledge with you the following securities:

.... (listed)

You are to hold the above securities as security for the payment of any and all clearance loans which you may hereafter make to us, and to deliver them to us, upon demand, at any time after all outstanding clearance loans have been paid.

It is understood that every such clearance loan is to be repaid at or before 3 o'clock P. M. of the day when it is made; and that, in default of such payment, you may sell, at public or private sale, without notice to us, any or all the above securities, at such time or times as you may deem advisable, and apply the proceeds to the payment of any unpaid clearance loans and any and all other indebtedness or liability from us to you at such time or times existing.

It is also understood that other securities may, with your consent, be substituted, from time to time, for any of the above securities, and that any such substituted securities shall be upon the same terms as the securities above mentioned.

Yours very truly,

.... (broker)

And the bank acknowledges receipt of the securities by the following letter:

Dear Sirs:

We have received your letter of this date and the securities mentioned therein, which we agree to hold upon the terms therein stated.

Yours very truly,
The .... Bank of New York

Then, whenever the broker wishes the bank to certify to an amount greater than he has on balance, he presents a day loan note, which reads:

New York, ... (date)

$..........

On demand, for value received ...... promise to pay to the ...... Bank of New York, or order, ... dollars, hereby agreeing that said Bank shall have a lien upon all property of the undersigned now or hereafter in its possession or under its control, as security for any indebtedness of the undersigned now existing or hereafter contracted, with the right at any time to demand additional security, and with the right, upon default in payment, to sell, without advertisement or notice to the undersigned, any or all of the securities or property so held, at public or private sale, or to otherwise dispose of the same in the discretion of any of the officers of said Bank, applying the proceeds upon the said indebtedness, together with interest and expenses, legal or otherwise, the undersigned to be liable for any deficiency.

.... (broker)

The amount of this note is placed to the broker's credit at once and the check presented is certified. This note is presented about 10 or 11 o'clock, and must be paid by 3 o'clock on the afternoon of the same day. No interest is charged on it; all the bank's profit is from the balances which the brokers agree to carry with it; the broker has the use of the funds for a business day, that is, for a few hours, and, except for the custom to the contrary, banks could legitimately ask interest, since the broker gets as much value out of the use of those funds for the few

hours as if it were named a call loan and he had the use of it a full day.

In 1919 the New York Stock Exchange organized the Stock Clearing Corporation, which took over the functions previously performed by the clearing house of the exchange. It introduced a day clearing, whereby it clears stock contracts and money loans. Contributions from members are received by it for a clearing fund. The scheme is designed to reduce the demand for day loans or overcertification at the banks. It reduces to a minimum the advances of banks to brokers for the purpose of paying off loans. Under the former system when a loan was called which the broker desired to reborrow, it was necessary for him to secure an intermediate credit from his bank for the purpose of paying off the loan. Under the new plan the banks send to the Stock Clearing Corporation the collateral of the loans to be paid off, and while the securities are there the old loans are paid and the new loans made, and at the same time changes in the collateral are effected. These operations are executed through a system of checks drawn on the clearing fund. By this means it was expected that the reduction of balances required at his bank would compensate the broker for his contribution to the clearing fund.

Margins on Stock Brokers' Loans

Margin may be defined as the excess of the market value of collateral security over the principal of the loan, which security the borrower is required to deposit for the lender's protection. The margin is usually stated in percentage of the market value of the collateral, and the percentage varies with the kind or kinds of collateral, with the steadiness of the market price of the collateral, with the bank, with the borrower, and with the special conditions attending the loan.

On regular stock exchange loans the custom of Wall Street is to require a 20 per cent margin on stocks or bonds or both.

This margin has become so fixed, as the general estimate which bankers place on the safety limit, that competition as between the banks does not tend to reduce it; inducements to customers are made by reductions in the interest rate rather than by reductions in the margin. Favors are scarcely ever shown in regard to margin; a firm having a good balance with the bank is required to keep its loans fully margined in the same way as the broker who has no account with the bank. However, the condition of the broker's box (the receptacle in which the broker keeps his securities in his office) has a great deal to do with the bank's liberality toward him with respect to margins and collateral. In the case of an "all-bond" loan, of which there are relatively few, the amount of margin may vary from 7 to 10 per cent on United States government bonds or approved municipal bonds, to 20 per cent on second-class railroad bonds. If a broker borrowing money offers the bank collateral made up entirely or principally of bonds of the mixed variety, the bank will require the regular 20 per cent margin. The majority of brokers figure fairly closely on margins, but a few make a practice of keeping, say, 25 per cent or more, on their loans at all times.

Requirements as to Collateral

Stocks and bonds have become the most common form of collateral, and the stocks and bonds most approved as collateral have until recently been the issues of railroads of good standing. In recent years securities of certain industrial corporations have attained to a rank co-ordinate with railroad securities. During the transition period it was the custom of Wall Street to require for loans at the best rates that at least a certain minimum percentage of the collateral consist of railroad securities, permitting the rest to be made up of industrials. Several things raised the status of industrials: (1) the increasing proportion of stock exchange transactions that were concerned with industrials rather than rails; (2) the greater steadiness of values and proved

stability and soundness of certain industrials; (3) the dearth of rails for collateral purposes, so many having been absorbed and removed from the market by the public. The ratio shifted from 65:35 to 50:50, and in 1919 certain banks began to make no discrimination between "mixed" and "all-industrial" and "all-rail" loans.

It is desirable also to have as pledged securities those whose market price is not too far below par and that they should be of a varied character, on the theory that in a falling market twenty issues would stand up better than would one security whose position was vulnerable. Diversity in the pledged securities, with market values approximating par, is provided for by a rule fixing the maximum number of shares that will be accepted for a loan, say, 2,000 shares for a loan of $100,000.

When the bank's money-broker places a loan with a stock broker in the board room, the stock broker notifies his house as to the amount, rate, and the name of the borrower. The broker's cashier or loan clerk then makes up on an envelope a list of the securities to be offered as collateral, and this, together with the securities themselves, is sent to the bank. If the loan is accepted, a check is given and the loan is started on its way through the loan department. A loan card is made out, giving the date, rate, name of borrower, list of securities, and the market price and value of the securities. These prices are put down by the clerk making the card, and are then checked by the bookkeeper after he enters the loan in the loan book. The card is next turned over to the margin clerk, who is responsible for its correctness during its stay in the bank.

Requirements as to Margins

During a dull market in which the price changes are small or are spread over a considerable period of time, it is fairly easy to keep the loans properly margined. The chief trouble is the substitution of other collateral. A change in the collateral is at once

noted on the proper card, together with the market price and value of the new security. The loan card is then retotaled to make sure that it is correct. In case the broker makes an error that is large enough to reduce the margin below the 20 per cent requirement, he is telephoned to send additional margin immediately. It rarely happens that a broker's loan has to be called on account of insufficient margin.

During a bull market, margin is being continually withdrawn, brokers or their customers are taking their profits, and securities at such times must be carefully repriced and the margin closely watched. The character of the loan also must be kept in mind. With prices of railroad securities advancing and the excess margin in them being withdrawn, the character of the collateral may be materially changed; from a desirable loan secured by well-mixed rails and industrials, it may quickly change to a loan of an undesirable kind.

Sentiment enters somewhat into the making of loans on collateral security, and stocks or bonds that are acceptable at one bank may be promptly refused at another.

A block of a certain stock among the securities to a loan may seriously affect the loan, even though the margin is ample. It occasionally happens that the objectionable securities can be taken out without reducing the margin below the 20 per cent requirement, and this is usually insisted upon by the loan clerk before he will accept the loan. On first thought this may seem strange, but should there be a bad break in the market and the margin on that particular loan fall to exactly 20 per cent, it becomes an undesirable loan if that undesirable security is still in the collateral.

During a bad break in the market practically everything else in the loan department is made secondary to the watching of margins. Other work can wait until after the exchange closes, but the reading of quotations from the tape must be made as fast as they are printed.

In the handling of loans for out-of-town customers the bank is possibly more exacting in regard to margins than it is for its own loans. In case the market price of some of the collateral slumps so that the margin falls a trifle below the 20 per cent margin, the bank will, in the case of loans for customers, ask immediately and peremptorily for additional margin, but in case of its own loans it will in all probability await developments in the stock market before making such a call.

Collateral Substitutions on Stock Brokers' Loans

It has been stated that it is desirable to accept as collateral only such securities as are good delivery upon the stock exchange. The term "rails" is therefore restricted to the stocks of railroad companies listed on the exchange, and "industrials" to the securities of manufacturing and mining concerns listed there.

The popularity and regard in which certain securities are held vary materially, and the star performers of today may become, in Wall Street parlance, the "cats and dogs" of tomorrow. For a long time bankers scorned curb stocks as collateral, owing to wide fluctuations in price, inaccuracy of quotations, and irresponsibility of persons in charge of new flotations. With less secrecy in the management of some of the industrials, and with better ticker facilities, closer supervision of trading, and a broadening and more stable market for such stocks, the rules of banks with respect to such collateral have been somewhat modified. Some of the most highly regarded stocks now dealt in on the stock exchange were first marketed on the curb; and as securities cannot be traded in at both places there has been when commissions were scarce, during lean years, quite a struggle between the two bodies of traders. The curb tries to keep its popular favorites, and the stock exchange tries to take them over as an attraction that will help to offset a dwindling business. Both the Metropolitan Street Railroad and the New Haven were until recently regarded as gilt-edged investments, selling well

above 200, and the permanency of their dividends was unquestioned. At present, however, they are scorned. Other stocks have risen in popular esteem, such as Union and Southern Pacific. The formation of railroad or industrial combinations may remove a stock from the market, and a court order dissolving the combination may restore the stock. The control of a road may be obtained by daring speculators of untried managerial ability, whose policy may reflect on the value of its stock as collateral.

These illustrations are sufficient to bring out the fact that, next to the actual making of a loan, the most important work in the loan department is the supervision of changes in collateral securing it. A loan of the highest type may be riddled in one day, and it is extremely necessary that its original character be preserved; that the desirability and marketability of the different items comprising its security be not allowed to vary; that in mixed loans the ratio of rails and industrials be maintained; and that the total number of shares be not allowed to multiply too fast. Some loans are changed daily, others on rare occasions, and a few are not disturbed at all during their period; the active loans, of course, require most attention.

Substitution tickets must be signed by a member of the brokerage firm making the substitution or by an accredited representative, after the form shown on page 850.

The signatures on the backs of the certificates of stock tendered must be known to the bank or be guaranteed by a member of the stock exchange; and all offerings must conform to the "Rules for Deliveries" of the exchange.

After the substitution has been made the ticket is handed to clerks who make the changes on the card showing the collateral to each loan and who record it in the loan ledger. The substitution tickets are not returnedto the broker, but are kept for reference for a reasonable length of time.

The complexion of a loan sometimes undergoes swift changes, but usually the borrower, intentionally or otherwise, brings about

the change slowly and in a less noticeable manner. For instance, with a long line of borrowers before the window the windowman cannot stop to examine the records on each substitution; so the

New York,....(date)

...............Bank of New York,

Will please deliver to the bearer from our loan of ....(date) for

$......(sum) (number).. shares ..(name of stock)..

.... " ....

.... " ....

.... bonds ....

.... " ....

and receive

.... shares ....

.... " ....

.... bonds ....

Respectfully,

..............(broker)

Figure 34. Substitution Ticket

borrower, if so inclined, may add 100 shares of undesirable stocks here and there, from day to day, until his loan has deteriorated. To guard against this the loan cards should be gone over at intervals, and loans in an unsatisfactory condition be speedily brought to the attention of the makers.

Rates of Interest on Stock Brokers' Loans

The rate of interest on brokers' loans must be watched as carefully as are the collateral and margins. The rates are determined by the brokers in the money crowd in the boardroom, and not directly by the banks. There are two important rates on call loans: the "renewal rate," and the rate on new loans. The volume of new loans made on the board is never more than a small percentage of the total stock market loans, so that the

renewal rate is the real rate of the day. Assuming that the amount of loans subject to the renewal rate of 20 per cent on a certain day is a billion dollars, the cost of carrying this loan for one day is approximately $550,000; and any broker who had borrowed, say, $20,000 to carry 100 shares of stock would have to pay more than $11 interest for the overnight loan. The importance of this rate is, therefore, quite evident.

Method of Determining Call Loan Renewal Rate

The call money market opens about 11 o'clock in the morning, by which time the banks have completed their clearing house transactions and have determined their position with regard to the day's business and the amount of call money they have to lend. Before this hour the bids for funds from stock brokers have been coming to the "money table" and been entered in the order in which they were received. By this time, too, the stock brokers have been operating on the exchange more than an hour and can gauge the general activity of the market. The proportion of the demand for mixed and all-industrial loans is observed. The demand for call loan funds is therefore quite definitely known before the supply appears. The closing rate and the amount of funds left unloaned on the previous day are kept in mind, as well as the general banking position and money movements. With these and other factors before them, the brokers make bids and offers for funds. It is on the number and strength of these bids and offers that the renewal rate depends. For example, money may be bid at 3 per cent, offered at 3¼ per cent, and $100,000 loaned at 3¼ per cent; or bid at 3¼ per cent offered at 3½ per cent, and $50,000 loaned at 3½ per cent; or offered in $100,000 lots at 3½ per cent, and several loans made at 3½ per cent. With this same condition prevailing at 11:30 o'clock, the expert in charge of the money table, the president of the exchange, and one or more of its governors, and three or four of the big money-lenders get together, on the floor of the exchange

or by telephone, and decide what shall be the proper renewal rate for the day. In the instance supposed they would probably fix upon 3½ per cent. As soon as the rate is determined it is posted on the floor of the exchange. This rate is then quoted over the news ticker, and its publication is anxiously awaited by the bank loan clerks, because in case of a change from the preceding day's rate these clerks hasten to get out the "rate notices" and "calls" by 12 o'clock, if possible.

Of course, the banks do not have to accept this renewal rate; they can arbitrarily fix a higher rate of their own. But if they do not conform, or nearly conform, to this rate, they will in all probability have a lot of money lying idle in their vaults before the end of the day. A very large Wall Street bank, in fact, can make its own renewal rate, but it seldom makes it more than ¼ per cent above the Street renewal rate and often only ⅛ per cent higher. Usually it makes it the same. Brokers may seek a bank's money, in spite of a trifle higher though fair rate, because of the bank's fair treatment, accessibility, and rapidity of service. Up-town banks may undercut the down-town banks from ⅛ to ¼ per cent in order to get loans, the cut being necessary to overcome the handicap of their relative inaccessibility. Nearly every bank in New York City changes the rates charged on "brokers'" loans to conform with the posted rate, and the only alternative for a borrower is to pay his loan or be charged the current rate. Inasmuch as nearly every bank charges the posted rate, it is impossible for the borrower to obtain money in New York by shifting his loan to some other bank. The renewal rate applies to all brokers' loans placed by the banks for themselves or for their correspondents, unless special arrangements are made to the contrary.

With a few exceptions it is not customary with the banks, when making advances in interest rates, to increase the rates on demand or call loans made to their own regular customers who keep deposit accounts with them, but these regular customers are

treated differently from the ordinary brokers or Street borrowers. Demand loans, secured by stocks and bonds, made by banks to their own officers or to officers of other banks, are also generally excepted from the high call rates.

Dangers of System of Rate Determination

It is the thought, presumably, of the coterie of men who fix the renewal rate that this rate will be the one that will clear the market for loans that day. It is based upon their estimate of the supply and demand for call loans that day. The money expert at the money table sounds the borrowers and lenders, on the floor or by telephone, and tries to gauge the market situation; the other members of the group make similar diagnoses. Obviously they may misjudge the situation; unforeseen factors may arise, and the rate fixed may prove too high or too low. Consequently during the day applications for loans and offers to loan come to the "table," and in the light of these bids and offers the call rate is adjusted so that it will clear the market for new loans. The "table" expert then apportions the loan money among applicants roughly in proportion to their demands. This apportionment, however, cannot be carried out exactly for several reasons: The offers may specify the size of loan to any one borrower, the kind of collateral (whether mixed or all-industrial), and the character of borrowers who will be acceptable; in general the customers of the loaning bank are favored; loans to banks are subject to the 10 per cent limitation; etc. During 1920 and 1921 it was a common occurrence to find "outside" money, as it is called—that is, money loaned at call but not through the agency of the money table—loaned at rates lower than those fixed in the stock exchange.

Various dangers in the call loan rate system have been pointed out. A small group of men determines these important interest rates; the rates are a powerful factor in the movement of security prices; the rate-makers are not forbidden to engage in stock

operations; there is opportunity, therefore, for manipulation of the market if these men are not honest; the temptation is surely very great. Wall Street call loans average above a billion dollars; a shift of the renewal rate from 6 to 18 per cent for one day would add $360,000 to the net profits of the lending banks of New York. High call rates probably attract funds from the interior and from legitimate lines and put them into speculative activities. They are used as an argument to defend high rates on time loans and tend, therefore, to embarrass corporate financial management. New York is the only money market where wide fluctuations of rates are known. The London market handles a much larger volume of business, but its rates are quite constant; the great need in New York is a wide discount market, which has a stabilizing effect.

Call loans are made in any amount from $10,000 to $500,000 each, but $50,000 is the lowest amount considered for quotation purposes; that is, $1,000,000 might be loaned at 4 per cent in lots of $100,000 each, and $35,000 at 4¼ per cent, but money would still be quoted at 4 per cent.

Factors Influencing Call Money Quotations

In an active money market the call rate is quite likely to make some quick changes, and the loan clerks must keep posted at all times on the different rate changes. For instance, money may open and renew at 3¼ per cent, but it does not necessarily follow that new loans will be made at this rate; for it frequently happens that within fifteen minutes after the renewal rate is made call money will be loaning above the renewal rate; also it is quite possible for a broker to renew his loans, say, at 4 per cent, borrow some other money through the day at 4½ and 5 per cent, and then pay 6 per cent for his balance loan late in the afternoon. Of course these various rates remain in force only for one day, or until the renewal rate is fixed the next morning, at which time all his loans will be renewed at the new renewal rate.

One of the greatest factors in causing sudden demands for funds is the calling of loans up to one o'clock; the stock broker who figured his position early in the day cannot know exactly what loans will be called; when a loan is called, he must borrow to replace the called funds. The loans of stock have the same effect; the lender of the stock may demand that it be returned, or the borrower may return it at will; if the broker replaces the stock successfully through the stock-loan crowd on the exchange, he can cut his borrowings at the bank; but if the borrower of the stock returns it, the lender will probably reborrow on it at the bank.

Another factor is the call loan funds placed by the metropolitan banks for their interior correspondents. These funds come later in the day according to how far west the correspondent is. The metropolitan banks are not sure, therefore, how much they will have to loan until the day has progressed. They may receive notice from the federal reserve bank, just before three o'clock, that some Pacific Coast bank has remitted for credit to loan in the Street; the rate at that time may be high or low, depending upon the supply and demand of funds at closing time.

Frequently the call money quotations for the day in the newspaper are somewhat as follows:

Opened at	4¾%
Renewals	5½
High	6
Low	4¾
Ruling rate	5½
Closing	3

The low closing rate does not signify that money is getting cheaper or that the bottom has fallen out of the money market and that call money is getting back to where it belongs; in all probability it means nothing more than that some broker has at the last moment found himself with an oversupply of money and loaned $50,000 at any rate he could get, and the demand for the

day being over, he must take a much lower rate than the ruling rate.

The loan department gets rate quotations by messenger service directly from the bank's representative in the money crowd and also on the news ticker. In addition to these channels of information, any sudden change is relayed by telephone through the office of said representative.

Call money usually commands a very low rate of interest, the prevailing rates before the war ranging from 1¼ to 2½ per cent, but it is subject to wide fluctuations. Very low rates promote speculative activity and a rising stock market, and high rates force heavy liquidation, falling prices, and depression. At times when a heavy demand for investment funds synchronizes with a heavy demand for commercial funds and a relative dearth of loanable funds, the call rate rises abruptly. "The call rate rose to 127 per cent on October 29, 1896; to 96 per cent on November 2, 1896; to 186 per cent on December 16, 1905; in 1906 to 60 per cent on January 2; to 30 per cent on April 5 and 6; to 40 per cent on September 5, and to 45 per cent on December 31." As explained elsewhere, the fundamental conditions which occasioned these wide variations were laid in our peculiar banking system of redeposited reserves and sectional and seasonal demands for money. One of the objects of the federal reserve system was to provide a system of rediscount whereby money rates would be stabilized. In this it has not been entirely successful to date, for in 1920 call loan rates ranged as high as 30 per cent.

The call loan rates charged in New York frequently exceed the legal rates allowed for commercial paper, but under the law they are not usurious, for the law specifically exempts from the 6 per cent limitation collateral call loans in amounts not less than $5,000, and the National Bank Law authorizes national banks to receive and charge, on any loan or discount, interest at the rate allowed by the state in which the bank is located.

Method of Determining Time Loan Interest Rates

Rates for time loans in Wall Street are not made on the board by the "money crowd," but are determined by a different set of money-brokers, who go around from office to office with their bids or offerings, as the case may be. Quite a number of money-brokers are engaged in this business, some of them making it a specialty. These money-brokers are either independent or attached to some stock broker's office. The time rates are made for 30-, 60-, and 90-day periods, and also for 4-, 5-, and 6-month periods; the tendency, however, is toward the shorter periods. The rates are published daily and indicate the true general condition of the money market, to a much greater degree, indeed, than does the call rate. Brokers wish to get a certain proportion of their loans on time and thus shift more of the risks onto the banks; but the banks are generally very conservative in making such long-time loans. When money tightens the bankers are in a more dominating position with respect to the stock brokers, and call loans displace time loans quite largely. Time rates are generally higher and steadier than call rates; the range of fluctuation in any week is scarcely ever more than 1 per cent and in the great majority of weeks is zero; and the tendency to vary is greater in the case of the longer loans.

Since time rates are made by individual bargaining by the various parties at various places and times during the day, frequently no one rate can be quoted, and therefore the prevailing range is usually quoted. For instance, the quotations of October 18, 1917, in the *New York Times*, were:

PREVAILING RANGE OF TIME RATES—OCTOBER 18, 1917

	On Mixed Collateral	On all Industrial Collateral
60 days	5¼% to 5½%	5½%
90 days	5¼ " 5½	5¾
4 months	5¼ " 5½	5¾ to 6%
5 months	5½	5¾ " 6
6 months	5½	5¾ " 6

As in the case of call rates, the character of the collateral is seen to affect the time rate. As a general rule the rate tends to rise as the length of the loan increases, but to this rule there are many exceptions, some of which are evident above. The difference between the rate on 60-day loans and 6-month loans rarely exceeds ½ per cent and tends to grow less as the length of the loan increases.

The loan department keeps not only a complete record of rates for each day of the year, but in the daily earnings book it records the daily average rate on each class of loans. These rate statistics are interesting besides being useful to adjust misunderstandings as to the change of rates on call loans.

Daily vs. Fortnightly Clearings

The New York Stock Exchange, through its Stock Clearing Corporation, has employed daily clearings; whereas the exchanges of London, Paris, Berlin, and Vienna have used term clearings, that is, fortnightly or weekly clearings. The fortnightly clearing and settlement plan occasions less duplication of the handling of securities and payments, fewer flurries in call money rates, less borrowing on call, than does the daily system, and efforts are being made to introduce the European plan in the United States. The establishment of the Stock Clearing Corporation in 1919, by the New York Stock Exchange, reduced both the amount of certification required by brokers for intermediate credits in case of called loans and also, by the clearing of security balances, the volume of payments required. Under the old scheme, when a member of the stock exchange clearing house bought 1,000 shares of United States Steel and sold 900 shares, he had a balance of 100 shares to receive and pay for on the following day. If, however, he bought 1,000 shares of United States Steel and sold 900 shares of Southern Pacific, no economy was effected. Under the new plan, in the case given, the proceeds of the delivery of the 900 shares of Southern Pacific go to reduce the debt caused by the

purchase of the 1,000 shares of United States Steel, and it is necessary only to provide for the payment of the difference.

Relation of the Call Loan Rate and the Commercial Paper Rate of Interest

The call and time rates for brokers' loans are dependent upon the supply of and demand for such funds. The supply consists of the loanable funds seeking temporary investment, as held by banks and bankers inside and outside New York City, including foreign banks and agencies of foreign banks, and by firms, individuals, and corporations. The contributors to the supply vary with the season and with the attractiveness of other opportunities for investment, either locally or in other markets. It is the policy of most banks to provide for their commercial clients first and to invest only the excess in call loans and commercial paper. The demand for call loan funds varies with the activity of the market; low rates in turn promote speculative activity. The demand is often very sudden and necessitous, and to call forth and assure a call loan fund sufficient to finance the securities market it is recognized that the limitation of the rate to the legal rate for commercial transactions is an intolerable restriction.

The federal reserve provides a source of funds for members by rediscounts, but the rediscount facilities are specifically denied to paper used in speculative activities on the stock and produce exchanges. Therefore, to assure themselves of a liquid secondary reserve, member banks are inclined to invest their surplus fund in rediscountable commercial paper rather than in call loans. Interior banks tend to send less of their excess funds to Wall Street, but invest it in commercial paper. But until a large discount market develops which absorbs the loan fund, call loans on stock exchange collateral will continue to be an important feature of our banking system. Moreover, the prevalence of high demand renewal rates will divert funds from the commercial paper market to the stock market, for some banks and some other

lenders will take advantage of the higher rates. This diversion restricts the commercial paper market and will in time force a higher rate on commercial paper. The two markets thereby react one upon the other. The commercial paper rate is affected by many factors which only indirectly affect the call loan rate. The commercial paper rate, as well as its seasonality, is much more steady. These facts are shown in the following graph (Figure 35):

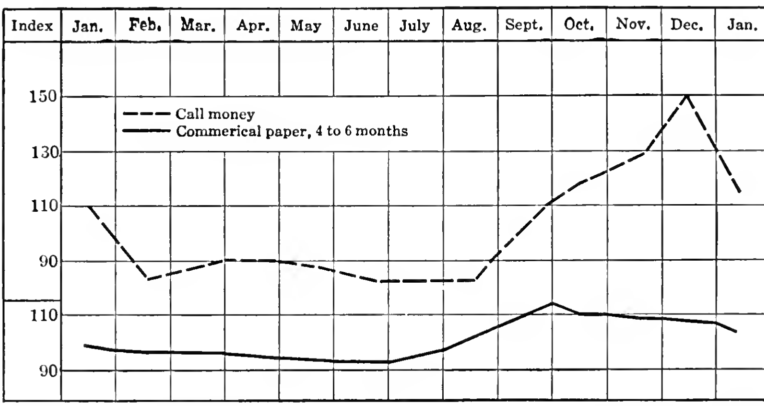

Figure 35. Graph Showing the Usual Seasonal Changes in Money Rates, Based on New York Quotations

Babson, April 27, 1920. Based on indices developed by W. M. Persons of Harvard University

The Collection and Computation of Interest

The rule of the Street is to allow the banks to collect interest on call loans at the end of each month for the actual number of days the loan has been in existence; more latitude is given in the case of time loans, special demand loans, and merchandise loans, on which interest is collected every three months. Few brokers pay their interest voluntarily, and in most cases the bank makes out and mails interest bills. When the principal of any loan is paid the interest on that particular loan is also paid, regardless of whether the borrower has other loans with the bank at that time.

The interest bills are commonly computed by one set of men and checked by another set, and are then entered in the interest book. The use of interest tables is discouraged in many of the larger banks, as figuring by head and hand, using, say, the old United States bank rate system, together with the 6 per cent method, has proved more speedy and accurate than the use of tables. To illustrate: the principle that the interest for 6 days at 6 per cent on $100,000 equals $100 (answer arrived at by pointing off three places to the left) can be varied to almost any requirement, where only one rate has been made during the life of the loan. But where a loan has run, say, for a month with several changes in rates during that time, the easiest rule to follow in such cases is to—

1. Multiply the number of days by the different rates.
2. Multiply the sum of these amounts by the multiple or fraction of $1,000 which the principal is (this can usually be done merely by pointing off to right or left).
3. Divide by 6 twice; thus the interest for a loan of $100,000, running for a month, at the following rates, would be computed:

6	days	at	6%	$ 36
6	"	"	5	30
4	"	"	4½	18
2	"	"	3	6
8	"	"	2¾	22
5	"	"	2½	12.50
31				6) 124.50 × 100
				6) 2075
				$345.83

The custom is to figure on a 31-day month and a 360-day year basis, so that the bank gets 31/360 of a year's interest on a month's loan, instead of 31/365, netting it a slight profit on all loans where interest is charged for the actual number of days elapsed.

The interest on time loans, not discounted loans, is figured at 30 days to the month.

In addition to the collection of interest on its own loans, the loan department is also responsible for the collection of interest on loans held for out-of-town banks. These loans are included with its own loans on the interest bills sent out, and, when paid, the interest is apportioned among the different banks to which it is due. The correspondent usually gets the same rate as the bank itself, and the loan is given the same care as to margin, collateral, and rates as its own, and the whole service is gratuitous.

CHAPTER XLIV

THE LOAN DEPARTMENT—OTHER LOANS

Merchandise Loans and Commodity Paper

Merchandise loans are those loans which are secured by commodities of various kinds represented by warehouse receipts and bills of lading. The notes and drafts and bills of exchange so secured are called "commodity paper." Commodity paper is defined by the Federal Reserve Board as "a note, draft, bill of exchange, or trade acceptance accompanied and secured by shipping documents or by a warehouse, terminal, or other similar receipt covering approved and readily marketable, non-perishable staples, properly insured."

This definition suggests many of the peculiarities of merchandise loans. In general, higher risks attend them, because the collateral is more likely to deteriorate than stocks and bonds; it is in the keeping of warehousemen or transportation companies whose facilities and financial character may be questioned; it is subject to shrinkage; and it is difficult to grade and describe with precision. Because of the greater risks banks must, with respect to certain collateral at least, insist upon higher rates or higher margins, or both, and use exceptional care in granting and watching the loans. Moreover, the loans are necessarily of short term. With due care and protection warehouse receipts and bills of lading can be made very excellent security; "grain paper," for example, has won a high position in the discount market.

Loans on such pledges are necessary to the good marketing of produce, and if banks fail to make merchandise loans they are not only losing a source of profit but are also not fulfilling their public duty. Warehouse receipts and loans based on them facilitate speculation in produce. The Federal Reserve Board has

authorized preferential rediscount rates for commodity paper; these rates are intended to assist actual producers during crop-moving periods and are not designed to benefit speculators, and for this reason the board reserves the right to suspend the special rates whenever it appears that the movement of crops has been practically completed. As the produce, say, cotton, for example, moves from farm to consumer, it may be financed by a series of loans, secured successively by cotton tickets, gin tickets, compress receipts, bills of lading, and warehouse receipts; the provision of capital for the whole commercial operation devolves upon the banks, and the producer and middleman can thus do business on slender means.

Legal Protection of Merchandise Loans

The first care in granting a merchandise loan is to see that the warehouse receipt or bill of lading is a bona fide, duly executed instrument, as evidence that the merchandise is in the custody of the transportation or warehouse company. The determination of these particulars has been very much aided: (1) by the adoption by the various states of the Uniform Warehouse Receipts Act and the Uniform Bills of Lading Act, prepared by the Commissioners on Uniform State Laws with the assistance of committees from the American Warehousemen's Association and the American Bankers' Association; and (2) by the Pomerene Bills of Lading Act of Congress, 1916. It is necessary that the bank know the signatures and forms used by the warehouse. The bank may also insist upon validation of the instrument by the issuing company.

To determine whether the merchandise conforms to the description as given on the receipt and whether it is in good condition, the banker either trusts the borrower who furnishes the list of goods, giving their weights and prices, and the various certificates of appraisals of the graders; or, in case he suspects that the borrower is not telling the truth, he makes an independent physi-

cal inspection or appraisal. Which procedure the banker follows will depend upon his regard for the borrower.

In the case of several staple goods the state warehouse commissions and the produce exchanges provide for the inspection and grading of commodities and for the regulation of warehouses and the issue of warehouse receipts. Especial effort is made to have the stored commodities conform rigidly to the inspection certificates and warehouse receipts as to weight and quality and to require financial responsibility of the warehousemen and to guard against the issue of false or spurious warehouse receipts. It is common to require that the receipts be registered with the state commission; and the commodity is described in terms of the grades established by the exchange or by the United States standards. Since the commodities can be most efficiently handled in bulk, standardization and grading are necessary and make possible warehouse receipts representing certain quantities of goods of a certain grade and not specific goods.

Risks of Loans on Staple Commodities

Banks should loan only on staple commodities which have a broad, steady demand, a stable price, and a well-organized market. Otherwise very high margins must be required to provide against possible inability to liquidate the collateral to advantage. Any commodity traded in on the produce exchanges meets these requirements. The prices quoted on these exchanges are also very useful to the margin clerk, who may require additional margin in case the market for the collateral of a loan is falling. On default of the borrower to pay upon demand or to provide additional margin, the bank may sell the collateral at once through a broker or may carry it along for a better market. The usual margin is 20 per cent or higher, varying with the stability of price, the natural shrinkage and deterioration in storage, the ease of liquidation, etc.

Another risk is that of the warehouse; it may or may not

adequately guard against loss by fire, moisture, too high or too low a temperature, etc. Warehouse receipts pledged as collateral should, therefore, be accompanied by insurance certificates or blanket policies. The produce exchanges approve certain elevators and warehouses as "regular" when they conform to certain specifications in construction, facilities, management, and financial responsibility, and warehouse receipts of these are "good delivery" on the exchange. The federal reserve bank approves certain warehouses of its district, the commodity paper secured by whose receipts is eligible to rediscount with it. In any case the loaning bank must pass upon the character of the warehouse whose receipts it is asked to accept.

Substitutions of Collateral on Merchandise Loans

Merchandise loans are made wholly upon one commodity or upon security of varied form, and the borrower is allowed to make substitutions of collateral. For instance, Richard Roe and Company, having obtained a loan for $100,000 on 120,000 bushels of Manitoba No. 1 wheat, would be allowed to withdraw 60,000 bushels and substitute warehouse receipts or bills of lading covering 50,000 bushels of corn and 25,000 bushels of oats. The maker of a loan for $50,000 secured by 1,000 bales of middling cotton could withdraw 500 bales and substitute 350 bales of sea island cotton. A loan originally on tea, in the course of time, may have as security cases of wax, barrels of oil, and rolls of matting. Since acceptance of substitution is a gratuitous service, the bank prefers that there be not more than one substitution per day.

Partial payments are frequent in this class of loan. The bank might receive a request as follows:

.... Bank, ...(date)
New York.

Enclosed find our check for $2,000 which kindly apply as part payment on our loan of $25,000 dated May 20, 1921, and hand bearer warehouse

receipt No. .... of New York Dock Company for 300 half-chests of tea in order that we may have 240 chests released. We will return said certificate to you in due course.

John Smith and Company.

While the requested warehouse receipt is in the possession of John Smith and Company, the bank is without security for part of the loan; and in such cases the bank either demands a certified check or a trust receipt pending the return of the certificate. Or, if the goods are to be shipped, the substitution ticket might read:

From our loan of $25,000 dated May 20, 1921, please hand bearer warehouse receipt No. .... issued by the New York Dock Company for .... chests of tea, for which we hand you our trust receipt.

John Smith and Company.

Loans on Bills of Lading

The essential difference between warehouse receipts and bills of lading is that in the case of the former the goods are in storage and in the case of the latter they are in transit. The usages so far as bank loans are concerned are very similar. One peculiarity is that in the case of loans on railway bills of lading the bills are seldom accompanied by insurance certificates because the railroads are liable for all ordinary forms of loss, damage, or unreasonable delay, subject to such exemptions as are authorized by the common law, the United States statutes, and the bills themselves; in other words, the burden of insurance is shifted to the railroads. If the uninsured goods are lost or damaged in transit through some cause for which the carrier is exempted from responsibility, the security, as represented by the bill of lading, is impaired or totally lost; but the shipper of the goods or the borrower who owns the goods and pledged the bill of lading may be a responsible person against whom the debt can be collected. If, however, both the shipper and the debtor are insolvent or financially irresponsible, the security fails.

Commonly when the bank gives the possession of the bill of lading to a party, it is provided with a trust receipt, by which said party agrees to hold the goods in trust for the bank's account. This receipt gives the bank a prior lien on the goods and makes the bank a preferred creditor, and the party violating the trust would be subject to criminal prosecution for misapplication of the funds. The bank is content to receive back the bill of lading, or the warehouse receipt for which it was exchanged when the goods were taken from car or vessel, or cash in settlement of the loan; any other use might be construed as a misapplication of funds.

Certain dangers attend loans on bills of lading. The bill does not guarantee the quality of the goods; the bill may be stamped "shipper's load and count," which indicates that the shipper has loaded and counted the shipment and that the carrier is not responsible for its correctness; the packages are merely "said to contain" such and such goods. It is therefore important to know the character and honesty of the shipper. Moreover, the bill may be a fraudulent issue and not binding upon the company. Since the bills are sometimes issued in duplicate or triplicate, delivery may have been made on the original, and the duplicate, outstanding but not marked, may be the one pledged for the loan; if any one of the set is sufficient warrant to deliver, possession of the entire set is necessary to guard a loan. By error or on purpose part of the goods represented by the bill may have been delivered and no indorsement of the delivery have been made on the bill. The goods may have shrunk, spoiled, or deteriorated en route, and be salable only at a discount, if at all. Stale bills are very apt to represent unsalable goods and should be carefully investigated.

The Rediscount of Commodity Paper

The Federal Reserve Board has from the first favored the use of commodity paper by prescribing preferential rates for rediscount, by furthering the warehouse movement, and by prepar-

ing a uniform system of accounting for warehouses. The Federal Reserve Act provided for the rediscount of notes, drafts, and bills of exchange arising out of actual commercial transactions and gave the board the right to determine and define the character of the paper thus eligible, but it specified that nothing in the act should be construed to prohibit such notes, drafts, and bills of exchange, secured by staple agricultural products, or other goods, wares, or merchandise from being eligible for such discount. The act further prescribed that notes, drafts, and bills admitted to discount under this paragraph must have a maturity at the time of discount of not more than ninety days, except that those drawn or issued for agricultural purposes or based on live stock and having a maturity not exceeding six months may be discounted in an amount to be limited to a percentage of the capital of the federal reserve bank, which percentage is to be ascertained and fixed by the Federal Reserve Board.

The limitations imposed by the board are:

1. That the aggregate of notes, drafts, and bills bearing the signature or indorsement of any one borrower rediscounted for any one member bank shall at no time exceed 10 per cent of the unimpaired capital and surplus of such bank.
2. That the commodity paper must conform to the requirements of the federal reserve bank relating to shipping documents, receipts, insurance, etc.
3. The item must be one on which the rate of interest or discount, including commission, charged the maker does not exceed 6 per cent per annum.

The board also requires that the commodities represented be "approved and readily marketable, non-perishable staples, properly insured."

The following table gives the distribution of commodity loans as among the leading commodities:

Loans of the National Banks, June 30, 1919, Secured by Warehouse Receipts

Amount loaned on security of warehouse receipts or terminal receipts:	
For cotton	$ 84 million
For wheat and other grains	29 "
For commodities other than cotton and grain	81 "
Total	$194 million

Handling the Collateral of Rediscount Paper

When a member bank rediscounts commodity paper, the matter of handling the collateral becomes difficult. In such a case the borrowing customer may wish the warehouse receipts to be held locally by the member bank where substitutions can be conveniently made; but it may not be regarded as sound banking to rediscount a loan and allow the warehouse receipts to remain in the hands of the borrowing bank. One method employed is to turn over the receipts to another designated bank in the same locality as the borrower, which bank holds the receipts under trust agreement with the reserve bank and permits the necessary collateral substitutions. This method is objectionable, however, because the banks are competitors and no bank cares to have a competitor obtain information in regard to its customers through holding warehouse receipts. Under regulations laid down by the Federal Reserve Board, a federal reserve bank is authorized to waive the requirement of a financial statement of the borrower with respect to any note discounted for a member bank in behalf of a depositor or another member bank, if the note is secured by a warehouse, terminal, or other similiar receipt covering goods in storage. In the case of the Federal Reserve Bank of New York, as a general rule the warehouse or other receipt covering goods in storage, together with insurance policies, accompanies the notes at the time they are offered for rediscount and is left with the

bank until the maturity of the notes; but this custom has to do particularly with notes of persons, firms, or corporations which do not make a financial statement. Where a recent statement shows a reasonable excess of quick assets over current liabilities the member bank is sometimes permitted to retain the warehouse receipt and insurance policy, but it gives instead its trust receipt and notifies the federal reserve bank to that effect. The reserve bank, however, considers separately the circumstances surrounding each case.

Loans to Banks

An important class of borrowers from reserve city banks is their correspondents. It is not customary for the lending bank to extend lines of credit to its correspondents, but each application is treated on its merit and specific amounts are loaned as needed. Many banks do, however, extend lines of credit to other banks. In general, the lending bank stands ready to supply the reasonable requirements of the correspondent, but only in proportion to the average balance carried and with due regard to the applicant's assets and borrowings elsewhere and within the limitations set by law. Larger loans would be granted to an applicant offering paper eligible for rediscount than to one offering ineligible paper.

Some reserve city banks have a formal rule that a minimum balance of 20 or 25 per cent of the borrowings must be carried with the lending bank; some fix a minimum amount for the balance, say, $2,500 or $3,000 for a bank with capital and surplus of $25,000. Exceptions are made to these rules on occasion, but chronic borrowers are favored less with exceptions than occasional borrowers. These balances make the account more profitable and also guide the lending bank as to the character of the management of the correspondent, for small balances with frequent overdrafts indicate that the correspondent is working with too small liquid assets.

Quite complete credit files are assembled by the reserve city banks to guide them in making loans to banks. The credit data are procured from representatives of the borrowing bank, from other correspondents, from the state superintendent and state bank examiner, from statements of the bank, from agency reports, and from personal visits by the field representatives of the reserve city bank.

Much of the borrowing is seasonal, particularly by correspondents in agricultural districts. The occasions are the planting, the harvesting, and the carrying of the grain or produce in warehouse or in transit. The maturities of the loans synchronize with the ends of these periods. Many reserve city banks insist upon a seasonal clean-up of the loan for a reasonable part of the year. Some of the loans, however, are for extraordinary needs and special purposes, for instance, the sudden and large withdrawal of government deposits or some change in the market situation.

The table on page 873 gives the distribution of loans by national banks to other banking institutions as among reserve cities, federal reserve districts, state and national banks, and forms of loans.

These figures, covering the three chief forms of interbank borrowing, include the great majority of such loans, but some bankers have always been reluctant explicitly to report interbank loans where non-committal ways were open. The general prejudice against bank borrowing which has existed until recently, the objection raised by customers to having their notes sent from the bank where they were originally negotiated, the tendency of business men to hesitate to depend for accommodation upon a bank which itself had to borrow, and the legal limitations which, with certain exceptions, restricted the bank's debts and liabilities to an amount not exceeding its capital stock, have caused some bankers to conceal as many of their borrowings as possible. The Comptroller of the Currency has pitted his wits against

Loans by National Banks to Other Banks and Trust Companies, March 4, 1919

(In thousands)

Cities	Amount Loaned to Borrowers in Same Federal Reserve District					Amount Loaned to Borrowers in Other Federal Reserve Districts				
	To National Banks		To State Banks and Trust Companies		Total	To National Banks		To State Banks and Trust Companies		Total
	On Bills Payable and Re-discounts	On Certificates of Deposit	On Bills Payable and Re-discounts	On Certificates		On Bills Payable and Re-discounts	On Certificates of Deposit	On Bills payable and Re-discounts	On Certificates of Deposit	
Central reserve cities:										
New York	$ 2,933	$ 260	$ 26,258	$ 508	$ 29,959	$21,399	$ 626	$39,945	$ 760	$62,730
Chicago	1,496	....	10,937	240	12,673	833	10	2,973	34	3,850
St. Louis	557	....	5,402	10	5,969	988	15	1,213	....	2,216
Total	$ 4,986	$ 260	$ 42,597	$ 758	$ 48,601	$23,220	$ 651	$44,131	$ 794	$68,796
Reserve cities:										
Total	18,402	5,270	87,082	9,067	119,821	2,906	90	10,726	420	14,142
Country banks:										
Total	2,680	1,318	26,292	4,079	34,369	202	396	914	915	2,427
Grand Total	$26,068	$6,848	$155,971	$13,904	$202,791	$26,328	$1,137	$55,771	$2,129	$85,365

these bankers in unearthing the concealed loans, but has found it impracticable to prevent violations of the law. Some of the methods of concealing interbank borrowings are:

1. To put them in with such items as "other liabilities," "notes or securities sold with agreement to repurchase," or "bills receivable rediscounted for the bank's benefit without recourse on the bank but with indorsement or guaranty of an officer or director of the bank."
2. To use the personal credit of some of the officers or directors of the borrowing bank.
3. To arrange a nominal sale to the directors or officers of some of the bank's bills receivable, indorsed without recourse, and let them rediscount or pledge this paper for a loan from another bank.[1]

Collateral and Margins of Bank Loans

The borrowing may be done by rediscounting or by loans on promissory notes. The loans are either unsecured or collateraled by bills receivable or securities. Some are demand loans, others time loans. Some borrowing is done by the use of certificates of deposit. The method of selling securities with an agreement to repurchase is also common. The proportion of loans secured by discounts to those secured by bonds varies among the borrowing banks, depending upon the volume and character of business done and upon the part of the country where the bank is located. The collateral is most frequently bills receivable. Occasionally borrowing is done on the personal note of the directors or officer, or else their personal indorsement is put on the note of the bank.

The margins required on these various classes of security vary with the lending bank. On loans secured by government bonds the usual margin is from 5 to 10 per cent of the market value; on loans secured by municipals, rails, industrials, or good mixtures,

[1] See *Federal Reserve Bulletin*, Jan. 1921, p. 33ff., and *Journal of Political Economy*, June 1921, p. 142ff.

it is 20 or 25 per cent; and on loans secured by bills receivable it is more variable, ranging from 20 to 100 per cent. The margin required varies also with the standing of the correspondent; in the case of first-rate correspondents no margin at all may be required.

The lending bank must assure itself that these securities are in good order. In many cases the collateral pledged is already in the possession of the lending bank, being held for safe-keeping in its customers' securities department; and in such cases it is very easy to know that the stock is properly assigned or that the bonds are good. Some of the collateral which is sent may consist of bank stocks, city or school district warrants, and these forms require careful scrutiny. Moreover, the loan value of these forms is difficult to determine. If the bank cannot fully satisfy itself that the collateral is perfectly good, it requires the borrower to substitute something else.

There are some banks in the stock yards district which operate cattle-loan companies in conjunction with their regular banking business. Such banks often offer for discount to other banks the cattle-loan company's bills payable secured by its customers' notes, which in turn are secured by cattle; or the cattle-loan company's bills receivable, secured by cattle and indorsed by the company, may be offered for discount. The buying bank, in loans of this character, receives either a chattel mortgage covering the cattle which secures the loan or the selling bank's trust receipt showing that the mortgage is being held for its account.

The collateral is generally held by the lending institution, but sometimes it is arranged that it be held, under trust receipt, by another institution in the vicinity of the borrower. This is more often the case when the borrower is far distant from the lender and it is desired to reduce the expense, inconvenience, and risk attending shipment of the collateral. It is also more common where the loan is for a very short time. Locating the

collateral near the borrower also makes the substitution much easier.

Examination and Substitution of Collateral for Loans to Banks

When bills receivable are received as collateral, the credit department prepares a list of them, headed by the name of the bank and below it the names of the makers of the bills receivable, names of indorsers, if any, the amounts, and the due dates. The commercial agency ratings are placed after the respective makers and indorsers, and the credit files are searched for all information at hand regarding these to help determine the value of the collateral. The receivables are examined carefully to see that they are in proper form, that the amounts in figures and in writing correspond and are not out of proportion to the ratings given the makers, that the datings are correct, that the notes mature within a reasonable time and are signed properly, that they are negotiable, and that they are properly indorsed. If the paper is irregular in any way, if the bank's information is not entirely favorable, or if the bank has too many notes made by one person, the borrowing bank is asked to submit other collateral for that to which exception is taken.

In addition to the above list, the credit department also prepares cards on which are recorded the names of the makers of the receivables, the date the collateral was received, from whom received, the amount and the maturity. These cards are filed under the names of the makers, with their respective addresses; so that by referring to these cards it can be ascertained at a glance how much paper of a certain maker is entered as security.

The note and collateral having been passed upon favorably, a letter is written to the borrowing bank advising the decision of the bank in the matter of its loan. This letter acknowledges receipt of the borrowing bank's letter with note and collateral and informs the borrowing bank that it has been credited with the proceeds of its note. The letter, before mailing, is sent, together

with the application letter, the application ticket, and the bank's credit folder, to the bank's officers to be finally passed upon by them and thus concentrate responsibility for loaning the bank's funds.

Some of the bills receivable frequently mature before the bank's own notes become due. Since the loaning bank wishes to maintain its usual margin in collateral security, both the loan and discount departments have forms by which they notify banks of early maturing paper and ask for substitutions. In case the bank has to return collateral before the substitutions are sent, the receivables are sent by registered mail, with the statement in the letter that they are forwarded for collection and remittance pending the receipt by the bank of other approved collateral in substitution for that returned. A follow-up system is used to make sure that the bank always sends the substitutions. Some correspondents voluntarily take the responsibility of watching the maturities of the pledged notes and remit new collateral in ample time for substitution, so that it never becomes necessary to notify them; but the majority of borrowing country banks are dilatory in this respect and their pledged paper must be carefully watched.

In 1919 the note-brokers in New York prevailed upon certain banking houses to quote a call loan rate on loans secured by pledged acceptances. This arrangement saves the note-brokers from the necessity of discounting their acceptances in an unfavorable market, for they can borrow on the security of the pledged acceptances enough to carry them. The call loan rate on acceptances is lower than the rate the note-brokers would otherwise have to pay because of their very high quality. The establishment of this call loan rate is a step in the development of a broader discount market in the United States. If such loans are called, the acceptances can be sold in the discount market.

Handling Applications for Loans

When an application for a line of credit is received, a ticket is prepared in the credit department and sent to a few departments

of the bank in order that certain figures may be entered on it to assist in deciding whether or not a line should be granted, and if so, its amount. The ticket bears the name and address of the applicant, the date when the application was received, the amount applied for, and the capital, surplus, and undivided profits of the applicant bank. The ticket goes in turn to the discount and loan departments and to the foreign division, and to the bookkeeper who has had the account of the applicant. The discount clerk enters the amount, if any, which is then owing that department, the amount of discounts to the applicant for the previous year, when and how long the applicant was last out of debt to the bank, whether or not interest is allowed on daily balances, the manner in which certain officers are authorized to negotiate loans for the applicant, when the last discount was made, when it matures, and the rate charged. The loan department enters the amount, if any, now owing to that department, the last rate charged, the amount of loans the previous year, and when and how long the applicant was last out of its debt. The foreign division states how much, if any, the bank owes it for bills purchased or for commercial credits. The bookkeeper enters the average balance for the past six months, the average balance for the same six months the previous year, and the present balance. The ticket is then returned to the credit department, and if complete, is approved by, say, two members of that department having authority; it is then ready for the bank officers. The credit folder is next examined to see how the information contained therein reflects on the applicant and what arrangements had been made with this particular applicant bank in the past. If all the information on file regarding the financial condition, standing, etc., of the applicant bank, and also the standing, ability, and integrity of the management, are all right, if the account has been conducted satisfactorily, balances being proportionate to the amount of the line asked, and if other conditions are favorable, the bank is probably willing to lend any reasonable sum.

No matter from whom an application comes, whether a bank, a corporation, a partnership, or an individual, the same sort of ticket is prepared and practically the same factors are taken into consideration. In the case of a borrowing corporation, the bank will require a copy of that portion of its by-laws which relates to the negotiation of loans, the signing of notes, etc.; if the corporation's by-laws do not cover this subject, its board of directors is asked to adopt a resolution authorizing the negotiation of loans and to send to the lending bank a certified copy of it. Because of the equal responsibilities of partners for debts of a partnership, such authority is not required of a firm, but where a firm employs a person not a member of the firm and delegates to him power to do certain things for the partnership, a certified statement of his authority is required.

Ratio of Loans and Balances—Forms of Loans

The customary ratio between loans and balances is 5:1, that is, an average balance of $5,000 would entitle the applicant to loans up to $25,000; but in cases of exceptionally desirable customers greater loans than are warranted by the 5:1 ratio may be allowed. On the other hand, in cases of second-class applicants the loans would be kept down rigidly to the usual ratio to balances, and any applicant appearing unworthy of credit would be refused an advance of funds regardless of the size of the account. It is customary with some banks and corporations to establish a line of credit with the reserve city bank for a year and re-establish it yearly. Others do not arrange for a maximum amount of loans, but send their notes with collateral whenever they need funds, and rely on the bank to make the advance. Having given a line of credit, the bank ordinarily carries out its promises; but if later good reasons appear why the loan should not be made, the line is canceled.

Four or more different forms of notes are used. One is an ordinary promissory note used for unsecured loans. Such loans

are made only to applicants who appear perfectly good; to insist upon collateral in such cases would probably cost the bank a good customer. This form is usually discounted. A second form is used for secured loans and is discounted. A third form is used for secured loans and carries interest to maturity or provides for the payment of interest at stated intervals. And the fourth form is a collateral note made payable on demand, the loan being payable at any time with accrued interest.

Time Limit, Renewal, and Cancellation of Loans

The commercial bank fixes the time limit on its loans, usually at six months, and it rarely loans for longer periods. A great many of the loans are renewed, however, but it is a sort of unwritten law that each borrower shall clean up his indebtedness with the bank, say, once a year. In no case should a bank obligate itself in advance to renew its loans; to do so would in reality be to make long-term loans. While it is not customary to extend demand loans to out-of-town banks, such as are made are practically payable at their option, and since the loan is therefore a fixture, the rate thereon should be as high as on time loans. Even in the case of those banks where demand loans can be called at will, the out-of-town bank may be distant and it takes a much longer time to get remittance than in the case of stock broker's loans. Call loans to stock brokers differ also from demand loans to out-of-town banks in that the rate on the latter is fixed for the time they run, but on the former the rate varies from day to day.

Occasionally banks or corporations may arrange their loans and then before the loans mature receive funds which make it unnecessary for them to have borrowed money. In such circumstances they would naturally like to take up their loans, and therefore they ask to be permitted to prepay their notes and be allowed a refund of interest for the unexpired time. The loaning bank does not encourage this practice, for a loan could be arranged when money rates are high and prepaid when they are

low; if the interest were refunded at the higher rate, the party might then borrow elsewhere at the lower rate; the practice would amount to a speculation on the rate of interest. If the refund, however, were computed at the rate prevailing when the loan is paid, speculation would be obviated.

When a borrower has an account at the bank, it is customary to charge the amount of the loan to his account at maturity. The note is then canceled, and if there be collateral with it, the note and collateral are returned to the borrower, unless the bank is otherwise instructed. Sometimes bonds held as collateral are turned over to the customers' securities department to be held for safe-keeping for the borrower. It is customary in the case of ordinary unsecured notes of a corporation to charge them at maturity and return them at the end of the month with the customer's other canceled vouchers; but when a check is sent for paying the loan, the note is returned at once when paid. If the borrower's balance is not sufficient to enable the bank to charge the loan, the borrower is advised of the facts, usually by telegraph, and he either remits funds or renews the loan. When the loan is carried past its maturity date, interest is charged for the additional time, the lending bank making its loans on a special form of note which protects it in such cases.

Records of the Loan Department

"Street loans" are made, as was stated above, either by the bank's money-broker on the board or, as frequently happens, by stock brokers keeping accounts with the bank who call the loan department on the telephone and inquire whether they can have a certain amount. The bank's instructions to its broker stipulate the total amount he is to loan and the parcellation of it; as he places it he advises the loan department by messenger of the names of the brokers to whom loans have been made and the amount loaned to each. When these loans are received, the loan clerk examines the collateral, etc.; and if acceptable, he ap-

proves it and passes it on for a cashier's check or credit. A clerk then prepares the card, to which reference was made above. Finally a permanent record is made by the clerk who has charge of the loan book. This record includes the date, the name of the broker, the amount, number of shares of each stock, or number of bonds, and the total, the loan being indexed under the name of the borrower and the amount.

The above description of handling call loans applies to all brokers' loans and brokers' special loans and also to all demand loans, whether to banks, firms, corporations, or individuals, on bills receivable or merchandise collateral. But in the case of a time loan, record of its due date is also made in the loan book, and entry is made in the "tickler," under the due date, as to the name of the borrower and the amount. This tickler is checked up and proved, say, weekly, so as to avoid any chance of a time loan not being paid on its due date. In case of a time loan made on bills receivable, the bills are entered in a tickler under due date of each bill, name of borrower, and the amount.

Substitutions are made by the substitutions clerk, and the proper entries are made on the loan card and in the loan book. In case of a substitution of bills receivable, the bills are stamped out of the tickler with the date of the return of the bills, and the bills received are entered on it.

When a broker's loan is paid, he sends a check together with the certificate that identifies the loan. Out-of-town customers either direct that the due loan be charged to their account or they forward a check in payment. These checks and charge tickets are collected by the clerk who cares for the "paid book"; they are assorted according to the kind of loan—that is, demand, brokers' special, special, merchandise, and time loans—and entries are made of the rate, name, amount, and interest. The loan is then stamped "Paid" in the loan book.

Some borrowers pay their interest voluntarily, but to most borrowers an interest statement is prepared and sent. Before

such a statement leaves the department it is entered in the interest book under name, amount of interest, and date when paid. This book is watched closely to see that the interest is received. The date to which the interest is paid is stamped on the loan card and loan book.

The loans journal embraces all loans made during the day. Its debits are distributed into demands, specials, time, and merchandise loans; its credits are distributed into general ledger, Cashier's account, individual ledger, and bank ledger.

In making up the figures for the day the bookkeeper prepares a total of loans made and loans paid, dividing each into demand, brokers' special, special, time, and merchandise loans, according to the different rates. The excess of loans made over loans paid, or vice versa, is respectively added to or subtracted from the total loans and must prove with the general bookkeeper.

Overdrafts—Disadvantages of Practice

In the financial statements of banks, "overdrafts" are sometimes included among the Loans and Discounts. The Comptroller of the Currency now requires that national banks carry and report overdrafts as such and not as loans. In order to report them as call loans the bank must hold an obligation of the party to whom the advance is made; in such case there would be no overdraft, for the operation would be equivalent to the ordinary loan transaction. Some banks have been known to include among their bills receivable checks which would otherwise overdraw the accounts upon which they are drawn. Presumably the checks were in that case regarded as demand notes. Some banks have been known to carry such checks among their special collection items, such as past-due notes and protested paper.

To allow an overdraft is equivalent to loaning the bank's funds. Overdrafts are an irregular and bad form of loan, however. The overdraft is unexpected by the bank and therefore interferes with the bank's plans and its reserves. It has no

definite date of maturity; it may run a day or a month or longer, but the banker does not know when the drawer will cover. It is an unauthorized loan, for it does not arise in the regular way through the loan department, but is usually passed upon quickly by the cashier or other official. It is usually an unsecured loan. It may, however, be secured by pledge of securities in advance of drawing, and it is not an uncommon practice of banks in certain areas to allow overdrafts freely for customers who arrange in advance for possible overdrafts and pledge securities to cover them. An overdrawn account puts the bank in a very undesirable position; the officers hesitate to press the drawing customer to observe good banking methods, lest they offend him and he refuse to repay. The overdraft is not available in case of need; it cannot be called or rediscounted. In case of liquidation the proportion of losses is greater from overdrafts than from loans secured by notes. There is a bad propensity for overdrafts to be converted later into loans, and such loans are of very poor quality indeed.

Overdrafts indicate carelessness or miscalculation on the part of the drawer; and if allowed, they indicate slipshod banking. The courts have repeatedly declared the practice of permitting overdrafts a violation of legitimate banking; the United States Supreme Court has held it a misapplication of the bank's funds and a connivance at their withdrawal, without security, in favor of certain privileged persons, and therefore whenever overdrawing is permitted by the cashier it is at his own peril and upon the responsibility of himself and his sureties. The bankers are opposed to the practice, and but for competition would have long since stopped it.

The Comptroller of the Currency has urged in recent years the desirability of reducing the overdrafts of national banks. In this campaign he has been very successful. The ratio of overdrafts to loans of national banks increased from about 1885 to 1902; since 1902 the ratio has declined until it reached about .2 per cent

in 1915. State banking departments have also waged a war on overdrafts with quite similar success.

Prevalence of and Remedies for Overdrafts

The prevalence of overdrafts varies inversely with the thoroughness of bank supervision and directly with the degree of competition among the banks. The states reporting most overdrafts are Iowa, Mississippi, Texas, Illinois, Missouri, Nebraska, Georgia, and New York. Iowa leads all other states. With the exception of New York these states are agricultural and their population is largely rural. The overdrawing is done to the same extent by both farmers and business men. The rural distribution of the population brings the customer and the banker into intimate personal relations, and in these circumstances it is more difficult for him to refuse to allow the overdraft. Moreover, in a large bank the officers who may allow overdrafts are more remote and difficult to approach than in a small bank. When competition between the banks is very keen, the bank is reluctant to refuse to allow an overdraft lest it alienate a customer to a competitor. It may also offer a prospective customer the privilege of overdrawing as an inducement to get the account. The number of banks in a state is some index of the degree of competition prevailing there; the rank of the states in number of banks is Iowa, Missouri, Illinois, Texas, Pennsylvania, etc.; these are also among the ranking states in the amount of overdrafts reported.

The remedies for overdrawing appear to be the raising of the plane of bank competition, the education of the population as to the objectionable character of overdrafts, legislation imposing penalties upon bank officers for allowing unsecured overdrafts, reduction of the number of banks by consolidations and branch banking, etc.

In most cases probably the drawer does not overdraw his account intentionally. The states are enacting "bad check"

laws to penalize the issue of bad checks. In Ohio, for instance, any person who, with intent to defraud, makes and delivers a check on a bank and who at the time has insufficient funds in that bank to cover the check, is guilty of a felony and punishable by fine and imprisonment. As against the maker, the making of a check, the payment of which is refused by the drawee, is deemed prima facie evidence of intent to defraud and a knowledge of insufficient funds in the bank. The burden of proof is thus placed upon the drawer.

CHAPTER XLV

THE LAW OF LOANS AND DISCOUNTS AND OF NEGOTIABLE INSTRUMENTS

Distinction Between Pledge, Mortgage, and Lien

Loans may be classified into "secured" and "unsecured," and those secured by pledge of personal property are called "collateral" loans. The legal phases of pawn, pledge, hypothecation, or collateral security are comprised in the law of bailments. A bailment is the delivery of goods or money by one person to another, who does not become the owner, but holds such goods or money in trust, for some special purpose, upon a contract, express or implied, that the trust will be faithfully executed. A pledge is a bailment to secure the performance of an obligation, with power of sale in case of default. In this form the bailment is merely incidental to the primary contract, the performance of which is secured by the pledge; the pledge is primarily a contract, secondarily a bailment, and it usually applies to the payment of a debt.

Pledges are closely allied to chattel mortgages and liens. In the law a pledge differs from a chattel mortgage in that "the pledgee secures only a special property accompanied by possession; the mortgagee acquires at once the legal title with, or more often without, possession, subject to be defeated upon performance of the condition. The title of the mortgagee becomes absolute, but upon breach of the condition; the title of the pledgee never becomes absolute, but upon default he acquires a power of sale."[1] A chattel mortgage must ordinarily be recorded to be valid as against third parties; a pledge need not, because possession passes. A lien and a pledge are alike in that they give the

[1] Goddard, Bailments, section 72.

lien-holder and pledgee respectively a special property and possession, but differ in that the lien-holder has no power of sale; he has himself the right to retain the thing, but this right is personal only to him and may not be transferred. All three are commonly used as security for debt, and in equity are subject to redemption upon payment of the debt.

The distinctions between pledge, mortgage, and lien are sometimes very nice; if ascertainable, the intention and understanding of the parties govern. Where personal property is given as security for a debt, accompanied by a change of possession, either actual or constructive, the transaction is commonly regarded as a pledge; and where it appears that the parties intended no more than giving a security, without a sale or change of property, the law assumes that it was intended as a pledge, and not as a mortgage.

Relation of Pledgor and Pledgee

The relation of pledgor and pledgee can arise only by mutual agreement of the parties, either express or implied from their actions. There must be a voluntary contract between competent parties. The nature of the debt which the pledged item secures is determined by the terms of the contract; the debt may be a debt of the pledgor or of some other party, and the pledge may be equally obligatory in each case if all proper parties have assented. The debt may be a future debt or a past debt; the security may cover one or many debts; it may be a conditional or absolute pledge, and may run for a limited time or for an indefinite time; and it may be a continuing security applying to any future contracts between the parties within the terms of the agreement. Unless otherwise stipulated the pledge is security for the whole and for every part of the debt; if part is paid or discharged there remains a perfect pledge for the rest of the debt; no part of the pledge can be reclaimed by the pledgee until the entire engagement is performed.

The pledgor need not be absolute owner of the thing pledged. If the pledgor has only a limited interest, the pledgee acquires no right to sell the whole property in the thing pledged, on default, lest he divest the ultimate owner of his rights; the pledgee can, however, sell whatever interest the pledgor had, but the buyer in such case only gets the right to hold the pledged item for so long a time and in the same way as the pledgor could have held it. A lien-holder cannot make a valid pledge of property covered by his lien; in such an attempt the courts would not sustain the pledgee against the owner, even for the amount of the lien; certain state statutes, however, clothe the lien-holder with the right to pledge property in his possession to the extent of his lien. At common law a factor or broker, although he has a lien on his principal's goods for advances made, cannot pledge them; he cannot pledge goods consigned to him, and the attempt to do so would not divest his owner of any rights nor vest any in the pledgee. A factor may, however, deliver possession of goods on which he has a lien to a third person, with notice of the lien and with the understanding that the delivery is made to such third person as agent of the factor and for the factor's benefit.

In some states these rules of the common law as to the power of a factor to pledge his principal's goods have been changed by statute. These statutes enable the factor to make pledges of his principal's goods, and the pledgee in such cases acquires rights superior to those of the principal, who, by placing the property in the factor's hands, clothes him with apparent ownership. If the pledgee takes the goods knowing that the pledgor holds them as factor, the rights of the owner are left intact; nor can a factor, in that case, pledge the principal's goods without the principal's consent. The purpose of these statutes is simply to protect bona fide pledgees, and they turn upon the question of reliance in good faith upon the indicia of title. If an owner of goods clothes another person with the indicia of ownership and this person pledges the goods, the owner cannot recover the goods

from a bona fide pledgee who took the goods without notice of the owner's rights. This power to make a valid pledge as against the owner holds even though the indicia of ownership were procured by fraudulent representation. A pledgee taking in good faith negotiable instruments in pledge, before maturity, for value, and without notice of any defect in the pledgor's title, acquires a valid holding title as against the owner. Buying stocks on a margin creates the relation of pledgor and pledgee between customer and broker. A partner may pledge firm property to secure a debt of the firm, but not to secure his private debt. A person acting in a trust capacity cannot pledge his trust property for his own debt.

What May be Pledged

For reasons of public policy, statutes prohibit the pledging of the pay of soldiers and pensions given by the United States. National banks are prohibited from making loans on their own stock deposited as collateral, unless it is necessary in order to prevent loss on a debt previously contracted in good faith. With these exceptions any legal or equitable interest whatever in personal property may be pledged, provided the interest can be put, by actual delivery or written transfer, into the hands or within the power of the pledgee. The general rule is that property not in existence or not yet acquired cannot be pledged; but a contract to pledge is valid, and the pledge may take effect when the property comes into existence or is acquired, provided rights of third persons have not intervened. Property which is potentially in existence, such as crops in the ground, may be pledged. The most common subject of pledge is incorporeal property, which term embraces a debt or property evidenced by negotiable instruments, such as bills of exchange and promissory notes, non-negotiable instruments, corporate stock, bills of lading, and warehouse receipts. Incorporeal property is pledged by delivery of the paper which represents the property.

Creation and Establishment of a Pledge

Delivery is essential to the establishment of a pledge. The pledge is created by delivering the subject of the pledge into the hands of the pledgee; without delivery no pledge exists. To protect the pledgee against third persons having claims against the pledgor, it is very necessary that the subject be put beyond the control of the pledgor and into the hands of the pledgee, for the pledgee cannot claim the existence of a pledge if there has been no delivery. Delivery by an agent of the pledgor, or to an agent of the pledgee, is sufficient. If some part of a larger quantity of goods is to constitute a valid pledge it must be separated from the rest and delivered.

Delivery may be actual or constructive. When property is in the possession of a third person, an actual delivery to the pledgee is not required and a constructive delivery is sufficient, such as delivering the recognized symbols of the thing, as the delivery of a warehouse receipt or the key of a warehouse in which goods are lodged or other indicia of control over goods or property. An order by the pledgor upon the keeper, or if the contract of a pledge be in writing, proper notice by the pledgee to the keeper, constitutes valid constructive delivery. After such notice the keeper ceases to be agent of the pledgor and becomes agent of the pledgee.

The pledgee may be in possession of the subject of the pledge from the beginning; as where goods already pledged are, by agreement of the parties, used to secure renewed or additional loans, and the subject may be held by the pledgee jointly with others, and actual delivery dispensed with. A mere agreement to deliver or to pledge does not affect the rights of third persons having subsequent claims on the pledgor. The pledgee acquires no rights under such an agreement until the delivery is actually made; when later, under such an agreement, delivery is made, it validates the pledge, but not as against intervening rights which would be affected. A pledge of incorporeal property is made by

delivery of the symbols of the thing. Although pledges of this kind of property are usually made by an assignment in writing, such an assignment is not necessary except in the case of corporate stocks.

A delivery with the intention to create a pledge suffices to create a pledge without writing or other act, except in the case of certificates of stock, where a writing is required unless the certificate has been indorsed in blank. To make a valid pledge of corporate stocks as against third parties, there must be a transfer on the books of the company, or a power of attorney authorizing the transfer, or some assignment or contract in writing by which the holder may assert title and compel a transfer when desired. The pledge of corporate stocks is effected by the transfer of the certificates rather than of the stocks themselves. By statute or by by-law of a corporation no transfer of stock is valid against the corporation unless made on the books of the company; but, as between the parties to a pledge, it suffices that the certificate is delivered with authority to the pledgee, or anyone whom he may name, to transfer it on the books of the company. Bills of lading and warehouse receipts may be pledged by mere delivery without indorsement, even if they are not made out "to bearer."

Rights of Pledgor and Pledgee

The rights and liabilities of the pledgor may be varied by special contract, with such terms as may be desired. In the absence of such contract, the law fixes the relations of pledgor and pledgee to each other and to third parties. The pledgor is liable for the original debt, and in case of default the pledgee may sell the pledge and apply the proceeds. Any excess is the property of the pledgor, but if the proceeds are less than the debt the pledgor still owes the balance. A pledgor impliedly warrants his absolute title to property delivered in pledge. Unless he gives the pledgee notice of the qualified nature of his title, he is liable

to the pledgee for the amount of any liens or encumbrances on the property which the pledgee is obliged to discharge to perfect his rights. The pledgor retains title in the pledge and has the right to assign, by sale or otherwise, his reversionary interest in it; the assignee in this case takes the property subject to the rights of the pledgee. After the pledgee has received notice that the pledgor has assigned, he becomes holder for the assignee. Both the pledgor and the pledgee have the right to sue third persons for injury to the pledged property; if the pledgor has assigned his rights the assignee acquires the right to sue third parties for injury to the pledge. The pledgor has the right to recover the pledged property by paying the debt or performing the engagement secured, and he cannot be deprived of this right at the time of making the contract by any terms in the contract or pledge. In some states pawnbrokers are allowed to sell the pledge and foreclose the pledgor's right to redeem it at the expiration of a fixed time, generally a year.

In case a valid pledge of property is made, the pledgee acquires, as to third parties, no better title than the pledgor had: if the pledgor's title was perfect or defective the pledgee's title is perfect or defective to the same degree; the pledgee's rights are no better than the pledgor's, with two exceptions: (1) if it is a case of pledge of negotiable instruments, or (2) if the owner of the property has clothed the pledgor with the indicia of ownership, such pledge made in good faith entitles the pledgee to hold against the real owners.

Thus, if certificates of stock are delivered in pledge, the indorsement of these or the signing of a right of attorney to transfer them is assumed to invest the holder with apparent ownership, and the pledgee who accepts them without notice and in good faith acquires good title. Or, if a person accepts negotiable paper before maturity, in the usual course of business, as collateral security upon a loan made at that time, he becomes a bona fide holder. The indorsement and delivery of the paper transfer to

the pledgee perfect title to the paper. Except in Wisconsin, the courts hold that taking negotiable instruments as collateral security for pre-existing debt constitutes the pledgee a holder for value.

If the pledgor is known to the pledgee to be an agent of the owner, the pledgee cannot acquire perfect title unless he inquires into the authority of the agent to make the pledge; nor can the pledgee hold against the owner if the pledgor has acquired possession of pledged certificates of stock by theft or fraud, or if the instruments, negotiable or non-negotiable, are forgeries, except under the Uniform Negotiable Instruments Law, or if the indorsements are forged. The pledgee may assign the interest which he acquires in the pledge; he may assign his whole interest, or he may subpledge it to secure his own debt; or he may turn it over to a third person to hold for him. His assignee or subpledgee, in turn, acquires the pledgee's title, but no more, with the same two exceptions noted above. The pledgee, before default of the pledgor, has the right to hold possession of the pledged security. On his death this right passes to his personal representatives and lasts until the debt is fully satisfied. If the pledgor or an outsider interferes tortiously with the possession of the pledgee, the pledgee may maintain detinue or replevin against such interferer, recover damages against the outsider, and, if the sum thus acquired exceeds his special interest, hold the residue as trustee for the pledgor.

The Keeping of the Pledge

Ordinarily the pledgee has no right to use the pledge in any way, unless by express or implied agreement or assent of the pledgor. He may not use the property pledged to its injury, and is allowed to use it only to the degree that is needful for its proper care, that is, to keep it in condition. To use it wrongly does not terminate the pledge, but makes the pledgee liable for resulting injury. If any profit or increase accrues from the collateral

during the life of the pledge, the pledgee is to hold such profit or increase as part of the security, using it to reduce the debt and holding any excess in trust for the pledgor. It is the pledgee's duty to keep and render a strict account of all income derived by him from the pledge; and if there is an obligation to employ the pledge at a profit the pledgee may be held liable for the profits which might have been received but for his negligence. The pledgee can collect dividends on stock and interest coupons on bonds; if the stocks run in the pledgee's name, he may vote them. On the other hand the pledgee is entitled to reimbursement for expenses necessary to keep and care for the pledge; if stocks held in pledge are assessed, the pledgee may charge the assessments to the pledgor.

In the keeping of a pledge the pledgee is required to exercise ordinary care, what constitutes ordinary care depending upon the nature and value of the pledge and other factors; it may be simply safe-keeping, as in the case of jewels, or storage in approved warehouses and insurance in the case of grain; in the case of negotiable paper the due diligence required of the pledgee is that of the holder, who would attempt to collect it when due lest the parties liable on it become insolvent. Neglect by the pledgee to collect these collateral instruments or delay on his part to collect them until the parties become insolvent makes him legally guilty of negligence. His proper duty is to present such paper for payment at maturity, and in case it is not paid give notice to the indorsers. Otherwise he is liable for losses; this rule, however, does not apply as against the pledgor himself. The pledgee would be liable if he neglected to use ordinary prudence and to put the collateral in suit to prevent loss.

Redemption, Termination, and Sale

Upon redemption it is the legal duty of the pledgee to redeliver, together with all profits and increase, the property pledged. The article redelivered must be the identical property

originally pledged where it is distinctive in character, but such identity is not necessary in the case of certificates of stock and bonds. If the pledgee wrongfully sells or misapplies the property pledged, he is guilty of conversion. There is conflict of opinion as to rule of damages in such cases; some hold it should be the value of the property at the time of its wrongful sale or misapplication; others, the value at the time of redemption and demand; others, an intermediate value. New York courts and the United States courts hold, in case of pledged property subject to fluctuations in value, that the damages should be the highest value within a reasonable time after the pledgor becomes aware of the conversion.

The pledge may be terminated by the pledgor either performing his full obligation or by defaulting. At maturity, upon default in redemption at the agreed time by the pledgor, the pledgee has the right: (1) to sue on the debt secured, and (2) to sell the pledged property in certain ways. The pledged property is still a mere security and does not become the property of the pledgee; he realizes either by suit or sale. He may simply continue to hold the property until it is redeemed. If he sells it, the excess of the selling price after his claim is satisfied is held in trust for the pledgor. He is not compelled to rest exclusively upon the collateral for repayment, unless there is some agreement, express or implied, to that effect. He may sue on the general credit of the debtor and recover a judgment against him for the full amount of the debt, without destroying or in the least affecting his lien on the property pledged; the debt remains until it is satisfied.

After the secured debt has become due and the debtor has failed to comply with the demand of the pledgee to pay, the pledgee, upon reasonable notice to the debtor of the time and place of sale, may sell the pledged property at public auction. The purpose of the notice is to enable the debtor to provide bidders there to bid up the price and to see that the sale is conducted fairly. To fail to give notice or to sell before notice, is a conver-

sion, and the pledgor may maintain trover. If the pledgor is otherwise informed of the time and place of the sale, notice is not necessary, but the burden of proving that the debtor had such knowledge is then upon the pledgee; the safest way is to have a formal written notice served upon him. By terms of the debt contract the debtor may waive the right of notice and may empower the pledgee to be a bidder at the sale, whereas otherwise the pledgee cannot, directly or indirectly, be a purchaser. The public sale is required so as to insure the best terms for the pledgor; but since such a sale for stocks, bonds, and similar securities would be slow and might result in loss by depreciation of values, a sale, after notice to the pledgor, on the stock exchange is regarded as the readiest method of collection. If a broker, for instance, is carrying stocks or bonds for a customer, he may, upon notice to the customer, sell the stocks or bonds on the exchange. If, however, the pledged property is commercial paper, upon default of payment by the pledgor the pledgee has no right, in the absence of special authority for that purpose, to sell the paper at public or private sale; he is bound to hold and collect it as it comes due, and apply it to the debt.

If the pledge is a general one, with neither the time of redemption nor the manner and time of sale stated in the contract, or if there are conflicting claims, or the title is doubtful, or if it is impossible to give notice and there is no adequate remedy at law, the pledgee would institute proceedings in a court of equity and have the court order a sale. The parties may have agreed in the pledge contract on the method of sale in case of default; but in the absence of such specifications the pledgee is bound, as if he were a trustee, to act in good faith and to try in all reasonable ways to render the sale most beneficial to the debtor, such as selling it in parcels or altogether, according to which is the more advantageous. Some states have special statutes regulating the sale of the pledge upon default of the pledgor, either as a substitute or additional mode of selling.

The pledge may be terminated in numerous ways:

1. By redelivery to the pledgor. This redelivery must not be simply for a special or temporary purpose, as a pledgor in such case is a mere bailee for the pledgee. The delivery may be a voluntary surrender of the pledge at any time before payment of the debt, a substitution of other security, or a waiver of his rights by the pledgee.

2. By the performance by the pledgor of the contract secured. This is the normal way of terminating the pledge. To refuse to redeliver the collateral when the payment of the debt is tendered at or after maturity is a conversion by the pledgee, and the pledgor may maintain trover; such tender of payment discharges the pledgee's lien on the collateral but the debt remains, and the pledgee has a right of action on that. In case the pledgee sues on the debt and his debt is paid by sale of other property by the court, such payment terminates the pledge. If several debts are secured by the same collateral, the pledgor may specify to which he would have any of his payments apply; and in case he does not so specify the pledgee may apply it as he sees fit.

3. By conversion by the pledgee. To refuse to redeliver the pledge upon payment or tender, to become a purchaser of it himself, or any act of a similar tenor constitutes conversion, and, if the pledgor so chooses, such acts operate to terminate the pledge at once.

4. By sale of the pledge in any of the above named ways.

5. By act of the pledgee resulting in injury to the pledge; in such case the pledgor may terminate the pledge. Pledges are not terminated by the death or bankruptcy of the pledgor.

Warehouse Receipts—Uniform Warehouse Receipts Act

One of the specific forms of bailment is that of warehousing. A warehouseman is engaged in the business of storing goods in his warehouse for hire. He is bound to exercise ordinary and reason-

able care of the goods entrusted to him, that is, to exercise reasonable care in the method of storing; he does not guarantee them against loss by accidental fire, theft, vermin, etc., but he is liable for negligence for want of reasonable care in providing against such loss. The burden of proof of negligence is on the customer, but failure or refusal by a warehouseman to redeliver goods entrusted to him, or the redelivery of goods in a damaged condition, is prima facie evidence of negligence enough to shift the weight of evidence. The custom of the business is for warehousemen, on receipt of goods for storage, to issue a receipt or delivery order which describes the goods and upon presentation of which the goods will be surrendered to the customer, or to his order if the receipt is negotiable.

The Commissioners on Uniform State Laws, in conjunction with the American Warehousemen's Association and the American Bankers' Association, in 1906 adopted and recommended to the legislatures of the various states, for passage, the Uniform Warehouse Receipts Act. Since that date practically every state has adopted this act in its statutes.

By this act a warehouseman is a person lawfully engaged in the business of storing goods for profit; on account of varying local conditions the states fix the limits as to who may carry on the business of warehousing. Warehouse receipts may be issued by any warehouseman. Such receipt must embody within its written or printed terms the following:

1. The location of the warehouse where the goods are stored.
2. The date of issue of the receipt.
3. The consecutive number of the receipt.
4. A statement whether the goods received will be delivered to the bearer, to a specified person, or to a specified person or his order.
5. The rate of storage charges.
6. A description of the goods or of the packages containing them.

7. The signature of the warehouseman, which may be made by his authorized agent.
8. If the receipt is issued for goods of which the warehouseman is owner, either solely or jointly in common with others, the fact of such ownership.
9. A statement of the amount of advances made and of liabilities incurred for which the warehouseman claims a lien. If the precise amount of such advances made or of such liabilities incurred is, at the time of the issue of the receipt, unknown to the warehouseman or to his agent who issues it, a statement of the fact that advances have been made or liabilities incurred and the purpose thereof is sufficient.

The warehouseman is liable, to any person injured thereby, for all damage caused by the omission from a negotiable receipt of any of these required terms. The warehouseman may insert in the receipt issued by him any other terms and conditions that he may see fit, provided they are not contrary to the Uniform Warehouse Receipts Act and are such as not in any wise to impair the obligation to exercise that degree of care in the safe-keeping of the goods which a reasonably careful man would exercise in regard to similar goods of his own.

Classes of Receipts

Warehouse receipts are of two classes: (1) non-negotiable receipts, in which it is stated that the goods received will be delivered to the depositor or to any other specified person; (2) negotiable receipts, in which it is stated that the goods received will be delivered to the bearer or to the order of any person named in the receipt.

The former is merely evidence of an ordinary contract of bailment; the latter is, in addition, the negotiable representative of goods. The warehouseman is required to mark plainly on any

duplicate receipts issued by him that they are duplicates, and on any non-negotiable receipts issued by him that they are non-negotiable. In the case of the warehouseman's failure to do so, a holder of a receipt who purchased for value the duplicate supposing it to be an original may hold the warehouseman for all damage caused, even though the purchase be after the delivery of the goods by the warehouseman to the holder of the original receipt; and a holder of a receipt who purchased for value a non-negotiable receipt supposing it to be negotiable may, at his option, treat such receipt as imposing upon the warehouseman the same liabilities that he would have incurred had the receipt been negotiable.

Liability of Warehouseman

A warehouseman, in the absence of some lawful excuse provided by the Uniform Warehouse Receipts Act, is bound to deliver the goods upon a demand either by the holder of a receipt for the goods or by the depositor, if such demand is accompanied with:

1. An offer to satisfy the warehouseman's lien.
2. An offer to surrender the receipt if negotiable, with such indorsements as would be necessary for the negotiation of the receipt.
3. A readiness and willingness to sign when the goods are delivered, if such signature is requested by the warehouseman.

The warehouseman may discharge his liability as to the goods by delivering them to:

1. The person lawfully entitled to the possession of the goods, or his agent.
2. A person who is either himself entitled to delivery by the terms of a non-negotiable receipt issued for the goods, or who has written authority from the person so en-

titled either indorsed upon the sheet or written upon another paper.

3. A person in possession of a negotiable receipt, by the terms of which the goods are deliverable to him or order or bearer, or which has been indorsed to him or in blank by the person to whom delivery was promised by the terms of the receipt or by his mediate or immediate indorsee.

Delivery to a person not lawfully entitled to possession of the goods makes the warehouseman liable for conversion to all having a right of property or possession, unless the delivery was as authorized in (2) or (3) above; and even if the delivery was so authorized he would be liable if, prior to such delivery, he had either been requested by or on behalf of the person lawfully entitled to a right of property or possession in the goods not to make such delivery, or had information that the delivery about to be made was to one not lawfully entitled to the possession of the goods.

When a warehouseman delivers goods for which he has issued a negotiable receipt and fails to take up and cancel the receipt, he is liable to anyone who in good faith purchases such receipt for value, for failure to deliver the goods to him, whether such purchaser acquired title to the receipt before or after the delivery of the goods by the warehouseman. This rule does not apply to non-negotiable receipts, nor to negotiable receipts after goods have been lawfully sold to satisfy a warehouseman's lien, or lawfully sold or disposed of because of their perishable or hazardous nature. The same exceptions apply to the rule that where a warehouseman delivers part of the goods for which he issued a negotiable receipt and fails to take up and cancel such receipt, or to place plainly upon it a statement of what goods and packages have been delivered, he is liable to anyone, who in good faith purchases such receipt for value, for failure to deliver all the goods specified in the receipt.

The alteration of a receipt does not excuse the warehouseman who issued it from any liability if such alteration was immaterial, authorized, or made without fraudulent intent. If the alteration was authorized, the warehouseman is liable according to the terms of the receipt as altered; if unauthorized, but made without fraudulent intent, he is liable according to the terms of the receipt before alteration. Material and fraudulent alteration does not excuse the issuing warehouseman from liability to deliver according to the terms of the receipt as originally issued, but does excuse him from any other liability to the person who made the alteration and to any person who took it with notice of the alteration. Any purchaser of the receipt for value without notice of the alteration acquires the same rights against the warehouseman which such purchaser would have acquired if the receipt had not been altered at the time of the purchase.

A warehouseman is liable to the holder of a receipt for damages caused by the non-existence of the goods, or by the failure of the goods to correspond with the description in the receipt at the time of issue. If, however, the goods are described in the receipt merely by a statement of marks or labels upon them, or upon packages containing them, or by a statement that the goods are said to be goods of a certain kind, or that the packages containing the goods are said to contain goods of a certain kind, or by words of like purport, such statements, if true, do not make the issuing warehouseman liable although the goods prove not to be of the kind which the marks or labels upon them indicate, or of the kind they were said to be by the depositor.

A warehouseman is liable for any loss or injury to the goods caused by his failure to exercise such care as a reasonably careful owner of similar goods would exercise, but he is not liable, in the absence of an agreement to the contrary, for any loss or injury to the goods coming despite the exercise of such care. Except in the case of fungible goods (those of which any unit is, from its

nature or by mercantile custom, treated as the equivalent of any other unit), the warehouseman must keep the goods so far separate from goods of other depositors, and from other goods of the same depositor for which a separate receipt has been issued, as to permit at all times the identification and redelivery of the exact goods deposited. But if authorized by agreement or by custom, a warehouseman may commingle fungible goods with other goods of the same kind and grade; the various depositors then own the commingled goods in common, and are entitled respectively to shares proportionate to their receipts; and the warehouseman is severally liable to each depositor for the care and redelivery of his share to the same extent and under the same circumstances as if the goods had been kept separate.

If the goods are deposited by the owner or his agent in good faith with a warehouseman who issues for them a negotiable receipt, they cannot, while in the possession of the warehouseman, be attached by garnishment or otherwise, or be levied upon under an execution, unless the receipt be first surrendered to the warehouseman or its negotiation enjoined. This protects the warehouseman. But the courts stand ready to aid a creditor whose debtor is the owner of a negotiable receipt, by injunction or otherwise, in attaching such receipt or in satisfying the claim by such means as is allowed at law or in equity.

Satisfaction of Warehouseman's Lien

The receipt must state the warehouseman's charges; except for charges for storage of those goods subsequent to the date of the receipt, the amount of each must be expressly stated, if the warehouseman expects to include them in his lien. He has a lien on goods deposited, or on the proceeds thereof in his hands, for all lawful charges for storage and preservation of the goods, for all lawful claims for money advanced, interest, insurance, transportation, labor, weighing, coopering, and other charges and expenses in relation to such goods; also for all reasonable charges

and expenses for notice and advertisements of sale, and for sale of the goods where default has been made in satisfying his lien. The warehouseman's lien may be enforced: (1) against all goods, whenever deposited, belonging to the person who is liable as debtor for the claims in regard to which the lien is asserted; and (2) against all goods belonging to others which have been deposited at any time by the person who is liable as debtor for the claims in regard to which the lien is asserted, if such person had been so entrusted with the possession of the goods that a pledge of the same by him at the time of the deposit, to one who took the goods in good faith for value, would have been valid.

A warehouseman's lien for a claim which has become due may be satisfied as follows: The warehouseman must give a written notice to the person on whose account the goods are held, and to any other person known to the warehouseman to claim an interest in the goods. This notice must be delivered in person or by registered mail addressed to the last known place of business or abode of the person to be notified. The notice must contain:

1. An itemized statement of the warehouseman's claim, showing the sum due at the time of the notice and the date or dates when it became due.
2. A brief description of the goods.
3. A demand that the amount of the claim as stated in the notice, and of such further claim as shall have accrued, be paid on or before a specified date.
4. A statement that unless the claim is paid within the specified time the goods will be advertised for sale and sold by auction at a specified time and place.

In accordance with the terms of this notice, a sale of the goods by auction may be had to satisfy the lien from the proceeds, including the reasonable charges of notice, advertisement, and sale. If the goods are of a perishable nature, or by keeping will

deteriorate greatly in value, or by their odor, leakage, inflammability, or explosive nature, will be liable to injure other property, the warehouseman may give such notice to the owner, or to the person in whose name the goods are stored, as is reasonable and possible under the circumstances, to satisfy the lien upon such goods and to remove them from the warehouse, and, in the event of failure of such person to satisfy the lien and to remove the goods within the time specified, the warehouseman may sell the goods at public or private sale without advertising; and if after a reasonable effort he is unable to sell such goods he may dispose of them in any lawful manner and incur no liability on that account. The net excess of the proceeds above the claims is returned to the rightful owner. Thereafter the warehouseman is free from liability to deliver the goods to the depositor.

Negotiation and Transfer of Warehouse Receipts

As to negotiation and transfer of receipts, the Uniform Warehouse Receipts Act follows the law of notes and bills. A negotiable receipt may be negotiated by delivery where, by the terms of the receipt, the warehouseman undertakes to deliver the goods: (1) to the bearer, or (2) to the order of a specified person, and such person or a subsequent indorsee has indorsed it in blank or to bearer. A negotiable receipt may be negotiated by indorsement of the person to whose order the goods are, by the terms of the receipt, deliverable. If any indorsement of a bearer or order receipt is to a named person the indorsee can negotiate it only by indorsement. A receipt which is not in such form that it can be negotiated by delivery may be transferred by the holder, by delivery, to a purchaser or donee. A non-negotiable receipt cannot be negotiated, but it can be transferred.

A person to whom a negotiable receipt has been duly negotiated acquires thereby: (1) such title to the goods as the person negotiating the receipt to him had or had ability to convey to a purchaser in good faith for value, and also such title to the goods

as the depositor or person to whose order the goods were to be delivered by the terms of the receipt had or had ability to convey to a purchaser in good faith for value; and (2) the direct obligation of the warehouseman to hold possession of the goods for him according to the terms of the receipt as fully as if the warehouseman had contracted directly with him.

A person to whom a receipt has been transferred but not negotiated acquires thereby, as against the transferor, the title to the goods, subject to the terms of any agreement with the transferor. If the receipt is non-negotiable such person also acquires the right to notify the warehouseman of the transfer to him of such receipt, and thereby to acquire the direct obligation of the warehouseman to hold possession of the goods for him according to the terms of the receipt. Prior to the notification of the warehouseman by the transferor or transferee of a non-negotiable receipt, the title of the transferee to the goods, and the right to acquire the obligation of the warehouseman, may be defeated by the levy of attachment or execution upon the goods by the creditor of the transferor, or by a notification to the warehouseman by the transferor or a subsequent purchaser from the transferor of a subsequent sale of the goods by the transferor; that is, the transferee of a non-negotiable receipt gets only the rights at common law of any purchaser of bailed goods, and the warehouse receipt amounts to nothing but evidence. But where a negotiable receipt is transferred for value by delivery, and the indorsement of the transferor is essential for negotiation, the transferee acquires also a right against the transferor to compel him to indorse the receipt, unless a contrary intention appears; the negotiation then takes effect as of the time when the indorsement is actually made.

A person who for value negotiates or transfers a receipt by indorsement or delivery, including one who assigns for value a claim secured by a receipt, unless a contrary intention appears, warrants:

1. That the receipt is genuine.
2. That he has a legal right to negotiate or transfer it.
3. That he has knowledge of no fact which would impair the validity or worth of the receipt.
4. That he has a right to transfer the title to the goods, and that the goods are merchantable or fit for a particular purpose whenever such warranties would have been implied, if the contract of the parties had been to transfer without a receipt the goods represented thereby.

A mortgagee, pledgee, or holder for security of a receipt, who in good faith demands or receives payment of the debt for which such receipt is security, whether from a party to a draft drawn for such debt or from any other person, is not by so doing deemed to represent or to warrant the genuineness of such receipt or the quantity or quality of the goods described in it.[2]

When a person negotiates and sells a warehouse receipt to another for value, he does not as an indorser incur the ordinary liabilities which attach to the indorser of bills and notes in case of default of the maker; he is more like the person who indorses a note "without recourse," for the indorsement of a receipt does not make the indorser liable for any failure on the part of the warehouseman or previous indorsers of the receipt to fulfil their respective obligations.

The Uniform Warehouse Receipts Act makes it criminal for a warehouseman—

1. To issue a receipt for goods not received or not actually under his control at the time of issuing such receipt.
2. To issue a receipt containing a false statement.

[2] The question early arose as to whether or not the pledgee of a cotton warehouse receipt obtains the first lien on the cotton in question, or whether his lien may be displaced by attachment or otherwise on account of any indebtedness due by the owner of the cotton for labor, rent, or any other account. The consensus of opinion of the legal representatives of several federal reserve banks was that the holder of a negotiable warehouse receipt is protected from all claims of subsequent creditors of the original owner of the commodity covered by the receipt. The rights of a pledgee of a warehouse receipt are apparently superior to the unsecured prior claims of the creditors of the pledgor. The pledgee's rights, however, seem inferior to all valid claims upon the commodity obtained prior to its deposit in the warehouse. Federal Reserve Bulletin, September 1915.

3. To issue duplicate receipts not so marked.
4. To issue receipts for goods owned in whole or part by himself and not stating that fact in the receipt.
5. To deliver goods without obtaining the negotiable receipt therefor and leave such receipt outstanding.

It is also made criminal for one to deposit and take a negotiable receipt for goods for which he has no title, or which are mortgaged or subject to a lien, and later to negotiate this for value with intent to deceive and without disclosing the defect of title or the existence of the lien or mortgage. Since an agent of a warehouseman may be authorized to make the signature of the warehouseman, the issue of a receipt by an agent for goods which have not in fact been received is criminal and makes the warehouseman responsible to the transferee of the receipt for the goods which it states have been received.

The United States Warehouse Act

The provisions of the United States Warehouse Act of 1916 have greatly improved the financial standing of warehouse receipts, for which purpose it was passed. The act defines "warehouse" as including "every building, structure, or other protected inclosure in which any agricultural product is or may be stored for interstate or foreign commerce." And the term "agricultural product" means cotton, wool, grains, tobacco, and flaxseed, or any of these.

By the terms of the act the Secretary of Agriculture is authorized to inspect, classify, and license warehouses and to prescribe, within the limitations of the act, the duties of warehousemen conducting licensed warehouses. The licenses are issued for one year, subject to renewal upon satisfactory showing. The warehouseman is put under bond to observe the obligations laid by the state and by the act upon warehousemen, as well as those assumed by him under contracts with his respective depositors.

The Secretary is also authorized to license competent persons to grade agricultural products stored or to be stored in a warehouse licensed under the act and to certificate the grade, or to weigh and certificate the weight, or both. These licenses are subject to revocation by the Secretary whenever he is satisfied that abuses are being practiced by the licensee.

The licensed warehouseman is forbidden to discriminate among applicants for storage space. The products stored in licensed warehouses are inspected and graded by persons duly licensed to grade the same under this act. The warehouseman is required to keep the agricultural products of one depositor so far separate from those of other depositors, and from other products of the same depositor for which a separate receipt has been issued, as to permit at all times the identification and redelivery of the products deposited. But, if authorized by agreement or by custom, a warehouseman may mingle fungible products with others of the same kind and grade, and is liable to each depositor for the care and redelivery of his share of the mass. He is forbidden to mix fungible agricultural products of different grades.

For all agricultural products stored for interstate or foreign commerce in a licensed warehouse, original receipts must be issued by the warehouseman, but he is forbidden to issue receipts for products not actually stored in the warehouse at the time of the issuance of the receipts. These receipts embody the location of the warehouse, the date of issue, the consecutive number of the receipt, a statement whether they are bearer or order receipts, the rate of storage charges, a description of the products stored, including the quantity and the identification marks, a statement of the grade according to standards promulgated by the United States, a statement whether the warehouseman is sole or part owner or no owner at all of the stored products, a statement of the advances made and of the liabilities incurred for which the warehouseman claims a lien, and such other terms and conditions

as the Secretary of Agriculture may prescribe, and the signature of the warehouseman or his authorized agent. Unless otherwise required by the law of the state wherein the warehouse is located, when requested by the depositor of other than fungible agricultural products, a receipt omitting the statement of the grade according to the official standards of the United States may be issued, if it has plainly and conspicuously embodied in its terms a provision that such receipt is not negotiable.

While an original receipt is outstanding and uncanceled by the warehouseman issuing the same, no other or further receipt may be issued for the product covered thereby or any part thereof. If the receipt is lost or destroyed, a new receipt may be issued like the first in all particulars, subject to the state and federal law, upon satisfactory security being given as prescribed by the Secretary of Agriculture.

The licensed warehouseman, in the absence of some lawful excuse, is required, without unnecessary delay, to deliver the products stored, upon demand either by the holder of the receipt or by the depositor, if such demand is accompanied with:

1. An offer to satisfy the warehouseman's lien.
2. An offer to surrender the receipt, if negotiable, with such indorsements as would be necessary for the negotiation of the receipt.
3. A willingness and readiness to sign, when the products are delivered, and acknowledgment that they have been delivered, if such signature is required by the warehouseman.

The warehouseman is required plainly to cancel the receipt upon delivery of the product.

The warehouseman must keep in a place of safety complete and correct records of all agricultural products stored in his warehouse and withdrawn therefrom, of all warehouse receipts issued by him, and of those returned to and canceled by him; and he must

report to the Secretary of Agriculture the condition, contents, operation, and business of his warehouse, in such form and at such times as the Secretary may require. The products stored, as well as the warehouse and the records, are subject to inspection by the Secretary.

Every person who shall forge, alter, counterfeit, simulate, or falsely represent, or without proper authority use, any license issued under this act, or who shall violate or fail to comply with any provision of the law relative to bonding, or who shall issue a false or fraudulent receipt or certificate, shall be deemed guilty of a misdemeanor, and upon conviction be subject to fine or imprisonment or both.

CHAPTER XLVI

THE LAW OF LOANS AND DISCOUNTS AND OF NEGOTIABLE INSTRUMENTS (Continued)

Bills of Lading—Terms of Issuance

Another branch of bailments having special importance to collateral loans is the law of carriers, which defines the rights and duties of shipper and carrier under the common law, or under modifications of the common law by special statutes. Covering to some degree the same subject matter is the law of bills of lading, which primarily deals with bills of lading as documents of title or as pieces of commercial paper, and only secondarily as defining the relations of shipper and carrier, in so far as these relations directly bear upon bills of lading as documents of title or as pieces of commercial paper. The Commissioners on Uniform State Laws, after five years of study and conference with bankers, railroad men, shippers, and others, adopted the Uniform Bills of Lading Act. This act has been adopted by most of the states for interstate commerce; and a similar act, known as the Pomerene Bill of Lading Act, was passed by Congress in 1916, to apply to interstate and foreign commerce.

A person or corporation whose business is the transportation of commodities by land or water or both, for hire, is a carrier. A carrier whose real vocation is other than carrying, but who undertakes to carry goods on occasion, gratuitously or for hire, is termed a "private" carrier; but a carrier whose regular vocation is carrying for hire is termed a "common" carrier. A common carrier is bound to carry in all cases when he has accommodation and when his fixed rates are tendered to him, and he is liable for all losses or injuries to the goods he is carrying except those which happen in consequence of the act of God, of the public enemy,

or of the owner himself. Common carriers include railroad, steamship, pipe line, and other companies. The bills of lading issued by common carriers are the only ones to which the above-named state and federal statutes apply, and they constitute practically all the bills of lading in use.

"A bill of lading is a written acknowledgment by the carrier of the receipt of the described goods, and an agreement, for a consideration, to transport and deliver the same at a specified place to the consignee or person designated therein." Every bill must contain within its terms the date of issue, the name of the person from whom the goods have been received, the place where the goods have been received, the place to which the goods are to be transported, a statement whether the goods will be delivered to a specified person or to the order of a specified person, a description of the goods or of the packages containing them, and the signature of the carrier. Except in a few cases, the courts have held that it need not be signed by the shipper, and that his acceptance of the bill binds him to the terms of the contract; the Uniform Bills of Lading Act provides that acceptance of a bill indicates assent to its terms. Negotiable bills must have the words "order of" printed thereon immediately before the name of the person upon whose order the goods are received; the printing prevents the alteration of straight bills into negotiable bills. The carrier is not barred from inserting in a bill issued by him any other terms and conditions which are not contrary to law or public policy, and which do not in any wise impair his obligation to exercise at least that degree of care in the transportation and safe-keeping of the goods entrusted to him which a reasonably careful man would exercise in regard to similar goods of his own. But any alteration, addition, or erasure in a bill after its issue, without authority from the carrier issuing the same, either by letter or in a notation on the bill, is void, whatever be the nature and purpose of the change, and the bill is enforcible according to its original tenor.

Classes of Bills of Lading

Bills of lading are of two classes. A bill in which it is stated that the goods are consigned or destined to a specified person is a non-negotiable or straight bill. One in which it is stated that the goods are consigned or destined to the order of any person named in the bill is a negotiable or order bill. By the statutes of several states, in the order bill, but not in the straight bill, the carrier contracts to require the surrender of the bill before the delivery of the goods; hence, since there are marked differences in the legal effect of the two documents, the Uniform Bills of Lading Act requires that a non-negotiable bill have placed plainly upon its face, by the carrier issuing it, "non-negotiable."

The issue of negotiable bills in parts or sets in the domestic trade is forbidden; if so issued, the carrier issuing them is liable for failure to deliver the goods described in the bill to any person who purchases a part for value in good faith. This prohibition is laid to prevent frauds; but because of the common practice of international trade to issue them in sets, the prohibition is laid only upon domestic trade. If duplicate bills are issued, they must be distinctly marked; and a carrier failing to observe this requirement is liable for the damage caused by his failure so to do to anyone who purchases the bill for value in good faith as an original bill. The issue of a plainly marked duplicate bill places upon the issuing carrier the same liability as of one who represents and warrants that such a bill is an accurate copy of an original bill properly issued, but places upon him no other liability.

Liability of Carrier

A carrier, in the absence of some lawful excuse, is bound to deliver goods upon a demand made either by the consignee named in the bill for the goods, or, if the bill is negotiable, by the holder thereof, if such demand is accompanied by:

1. An offer in good faith to satisfy the carrier's lawful lien upon the goods.

2. An offer in good faith to surrender the bill, properly indorsed, which was issued for the goods, if it is negotiable.
3. A readiness and willingness to sign, when the goods have been delivered, an acknowledgment that they have been delivered, if such signature is requested by the carrier.

A carrier is justified in delivering goods to one who is:

1. A person lawfully entitled to the possession of the goods.
2. The consignee named in a non-negotiable bill for the goods.
3. The holder of a negotiable bill properly indorsed to him.

He is liable for misdelivery if he delivers to one not lawfully entitled to possession of the goods, except as authorized in (2) and (3) just enumerated and even then he is liable if he had been requested by or on behalf of a person having a right of property or possession in the goods not to make such delivery, or had information at the time of delivery that it was to a person not lawfully entitled to the possession of the goods.

If a carrier delivers goods for which a negotiable bill has been issued, the negotiation of which would transfer the right to the possession of the goods, and fails to take up and cancel the bill, such carrier is liable for failure to deliver the goods to anyone who for value and in good faith purchases the bill. If a carrier delivers part of the goods for which a negotiable bill has been issued, and fails either: (1) to take up and cancel the bill, or (2) to place plainly upon it a statement that a portion of the goods has been delivered, with a description of the goods that have been delivered or still remain, he may be held liable for failure to deliver all the goods specified in the bill, to anyone who for value and in good faith purchases it.

A very important provision is that setting the liability for non-receipt or misdescription of the goods. Such a provision is found in both the Pomerene Act and the Uniform Bills of Lading

Act and gains its importance from the fact that bills of lading are no longer mere contracts of affreightment, but have become instruments of credit upon which millions of dollars are yearly advanced. The provision makes the carrier liable to a bona fide consignee or banker who pays or loans money upon a bill of lading issued by an authorized agent, certifying the receipt of goods although no goods in fact have been received. It makes the principal responsible for the act of an agent or employee, the scope of whose actual or apparent authority includes the issuing of bills of lading to one who in good faith has given value relying upon the description therein of the goods, for damages caused by the non-receipt by the carrier, or a connecting carrier, of all or part of the goods or their failure to correspond with the description in the bill at the time of its issue. If, however, the goods are described in a bill merely by a statement of marks or labels upon them or upon packages containing them, or by a statement that the goods are said to be goods of a certain kind or quantity or a certain condition, or it is stated in the bill that the packages are said to contain goods of a certain condition, or that the contents or condition of the contents of the packages is unknown, or words of like purport are contained in the bill, such statements, if true, do not make liable the carrier issuing the bill, although the goods are not of the kind or quantity or in the condition which the marks or labels upon them indicate, or of the kind or quantity or in the condition they were said to be by the consignor. The carrier may also, by inserting in the bill the words "shipper's load and count," or other words of like purport, indicate that the goods were loaded by the shipper and the description of them made by him; and if such statement is true the carrier is not liable for damages caused by the improper loading or by the non-receipt or the misdescription of the goods described in the bill.

Instead of taking the extreme position that no attachment, garnishment, or levy can be made on property for which a nego-

tiable bill is outstanding, the Uniform Bills of Lading Act makes it a condition of such seizure that the negotiation of the bill be enjoined or the bill impounded. If goods are delivered to a carrier by the owner or his authorized agent, and a negotiable bill is issued for them, they cannot thereafter, while in the possession of the carrier, be attached by garnishment or otherwise, or be levied upon under an execution, unless the bill is first surrendered to the carrier or its negotiation enjoined; and the carrier can in no case be compelled to deliver the actual possession of the goods until the bill is surrendered to him or impounded by the court. In such cases the court stands ready to assist by injunction or otherwise a creditor whose debtor is the owner of a negotiable bill.

If a negotiable bill is issued, the carrier has no lien on the goods therein mentioned, except for charges on those goods for freight, storage, demurrage, and terminal services, and expenses necessary for the preservation of the goods or incident to their transportation subsequent to the date of the bill, unless the bill expressly enumerates other charges for which a lien is claimed. In such cases there is also a lien for the charges enumerated, so far as they are allowed by law and the contract between the consignor and the carrier. After goods have been lawfully sold to satisfy a carrier's lien, or because they have not been claimed, or because they are perishable or hazardous, the carrier is freed from liability for failure to deliver the goods to the consignee or owner of the goods, or to a holder of the bill given for the goods when they were shipped, even if such bill be negotiable.

The Uniform Bills of Lading Act and the Pomerene Act give full negotiability to order bills of lading, and thereby afford greater protection to the discounting banker and to the purchaser of the goods. Where they acquire a bill of lading in good faith, that bill is made enforcible and is not subject to some unknown defect in the title of a prior holder. Negotiable bills may be negotiated by delivery or by indorsement, depending upon the

terms of the bill. A negotiable bill may be negotiated by any person in possession of the same, however such possession may have been acquired, if by the terms of the bill the carrier undertakes to deliver the goods to the order of such person, or if at the time of negotiation the bill is in such form that it may be negotiated by delivery. The person to whom a negotiable bill has been duly negotiated acquires thereby: (1) such title to the goods as the person negotiating the bill had or had ability to convey to a purchaser in good faith for value, and also such title to the goods as the consignee and consignor had or had power to convey to a purchaser in good faith for value; and (2) the direct obligation of the carrier to hold possession of the goods for him according to the terms of the bill, as fully as if the carrier had contracted with him directly.

Negotiation or Transfer of Bills of Lading

Negotiation of bills of lading is differentiated from transfer of such bills. A bill may be transferred by the holder by delivery, accompanied with an agreement, express or implied, to transfer the title to the bill or to the goods represented thereby. A person to whom a bill has been transferred but not negotiated acquires thereby, as against the transferor, the title to the goods, subject to the terms of any agreement with the transferor, and as against third parties he acquires such title as his transferor had. If the bill is non-negotiable, such person also acquires the right to notify the carrier of the transfer to him of such bill, and thereby to become the direct obligee of whatever obligations the carrier owed to the transferor of the bill immediately before the notification. Prior to the notification of the carrier or transferee of a non-negotiable bill, the title of the transferee to the goods, and the right to acquire the obligation of the carrier, may be defeated by garnishment or by attachment or execution upon the goods by a creditor of the transferor, or by a notification to the carrier by the transferor, or a subsequent purchaser from the

transferor, of a subsequent sale of goods by the transferor. To be binding upon the carrier the notice must be made to an officer or authorized agent, and such officer or agent is allowed reasonable time to communicate with the agent or agents having actual possession or control of the goods. Where a negotiable bill is transferred for value by delivery, and the indorsement of the transferor is essential for negotiation, the transferee acquires the right against the transferor to compel him to indorse the bill, unless a contrary intention appears.

A person who negotiates or transfers for value a bill by indorsement or delivery, including one who assigns for value a claim secured by a bill, unless a contrary intention appears, warrants:

1. That the bill is genuine.
2. That he has a legal right to it.
3. That he has knowledge of no fact which would impair the validity or worth of the bill.
4. That he has power to transfer the title to the goods, and that the goods are merchantable or fit for a particular purpose whenever such warranties would have been implied if the contract of the parties had been to transfer without a bill the goods represented thereby.

A mortgagee or pledgee or other holder of a bill for security who in good faith demands or receives payment of the debt for which such bill is security is not deemed by so doing to represent or to warrant the genuineness of such bill or the quantity or quality of the goods therein described.

Buyer's and Seller's Title to Goods

The Uniform Bills of Lading Act provides that the form of the bill indicates the rights of the buyer and seller of goods represented thereby. Where goods are shipped by the consignor in accordance with a contract or order for their purchase, the form

of the bill indicates the transfer or retention of the property or right to the possession of the goods as follows:

1. Where by the bill the goods are deliverable to the buyer or to his agent, or to the order of the buyer or his agent, the consignor thereby transfers the property in the goods to the buyer.

2. Where by the bill the goods are deliverable to the seller or to his agent, or to the order of the seller or of his agent, the seller thereby reserves the property in the goods; but if, except for the form of the bill, the property would have passed to the buyer on shipment of the goods, the seller's property in the goods is deemed to be only for the purpose of securing performance by the buyer of his obligations under the contract.

3. Where by the bill the goods are deliverable to the order of the buyer or of his agent, but possession of the bill is retained by the seller or his agent, the seller thereby reserves a right to the possession of the goods as against the buyer.

4. Where the seller draws on the buyer for the price, and transmits the draft and bill together to the buyer to secure acceptance or payment of the draft, the buyer is bound to return the bill if he does not honor the draft, and if he wrongfully retains the bill he acquires no added right thereby.

If, however, the bill provides that the goods are deliverable to the buyer, or to the order of the buyer, or is indorsed in blank or to the buyer by the consignee named therein, one who in good faith purchases for value the bill or goods from the buyer obtains the title to the goods, although the draft has not been honored, if such purchaser has received delivery of the bill indorsed by the consignee named therein, or of the goods, without notice of the facts making the transfer wrongful.

Where the seller of goods draws on the buyer for the price of the goods and transmits the draft and a bill of lading for the goods either directly to the buyer or through a bank or other agency, unless a different intention on the part of the seller appears, the buyer and all other parties interested are justified in assuming:

(1) that if the draft is by its terms or legal effect payable on demand or presentation or at sight, or not more than three days thereafter (whether such three days be termed days of grace or not), the seller intended to require payment of the draft before the buyer should be entitled to receive or retain the bill; (2) that if the draft is by its terms payable on time, extending beyond three days after demand (whether such three days be termed days of grace or not), the seller intended to require acceptance but not payment of the draft before the buyer should be entitled to receive or retain the bill.

These assumptions are applicable and valid whether by the terms of the bill the goods are consigned to the seller or to his order, or to the buyer or to his order, or to a third person or to his order.

Where a negotiable bill has been issued for goods, no seller's lien or right of stoppage in transit can defeat the rights of any bona fide purchaser for value to whom such bill has been negotiated; and the carrier is neither obliged to deliver nor justified in delivering the goods to an unpaid seller unless such bill is first surrendered for cancellation. With the foregoing exception, the Uniform Bills of Lading Act does not limit the rights and remedies of a mortgagee or lien-holder whose mortgage or lien on the goods would be valid apart from this act, as against one who for value and in good faith purchased from the owner, immediately prior to the time of their delivery to the carrier, the goods which are subject to the mortgage or lien, and obtained possession of them.

Fraudulent Use or Negotiation of Bills

The Uniform Bills of Lading Act and the Pomerene Act also strengthen the bill of lading as a commercial instrument, by making the issue of bills under certain conditions criminal offenses and by affixing severe penalties. Any officer, agent, or servant of a carrier, who with intent to defraud issues or aids in issuing a

bill, knowing that all or any part of the goods for which such bill is issued have not been received by such carrier, or are not under the carrier's control at the time of issuing such bill, is criminally liable. Likewise, for an officer, agent, or servant of a carrier to issue, with the intent to defraud, a bill for goods, knowing that it contains any false statement, makes him criminally liable. The issue, with the intent to defraud, of duplicate negotiable bills not plainly marked "duplicate" makes the issuer guilty of crime if he knows that a former negotiable bill for the same goods, or any part of them, is outstanding and uncanceled. The same applies in case of issue of non-negotiable bills not marked "non-negotiable."

It is made a crime for a person to ship goods to which he has no title, or upon which there is a lien or mortgage, and to take for such goods a negotiable bill, which he afterwards negotiates for value with the intent to deceive, and without disclosing his want of title or the existence of the lien or mortgage. Any person who with intent to deceive negotiates or transfers for value a bill, knowing that any or all of the goods which by the terms of such bill appear to have been received for transportation by the carrier which issued the bill are not in the possession or control of such carrier, or of a connecting carrier, without disclosing this fact, is guilty of a crime. Finally, any person who with intent to defraud secures the issue of a bill by a carrier, knowing that at the time of such issue any or all of the goods described in such bill as received for transportation have not been received by such carrier, or an agent of such carrier, or a connecting carrier, or are not under the carrier's control, by inducing an officer, agent, or servant of such carrier falsely to believe that such goods have been received by such carrier or are under the carrier's control, is criminally liable.

Statutory Limitations on Loans and Discounts

The governments both of the states and the United States have deemed it expedient to limit the power of the banks, in their

respective jurisdictions, to make loans. The laws and regulations of the various states differ much among themselves, but in general they apply to the same features of loans and are less restrictive than those of the national banking system. One of the reasons for the relatively rapid extension of state banks over national banks was the comparative freedom to make loans enjoyed by the former, and one of the common objections offered by state banks to entering the federal reserve system was the loss or restriction of their loan powers. Since in the compass of this chapter it is impossible to present adequately the restrictions laid by the various states on their banks, only those on the national banks will be given. The federal limitations include the following:

1. Loans on Bank's Capital Stock

National banks may not lend upon their own capital stock.

> No association shall make any loan or discount on the security of the shares of its own capital stock, nor be the purchaser or holder of any such shares unless such security or purchase shall be necessary to prevent loss upon a debt previously contracted in good faith; and stock so purchased or acquired shall, within six months from the time of its purchase, be sold or disposed of at public or private sale; or, in default thereof a receiver may be appointed to close up the business of the association.[1]

A loan made by a national bank upon the security of its own stock is not void, but only voidable; no penalty is imposed upon either the bank or the borrower for a violation of this section. If a bank which has loaned upon the security of its own stock is compelled to take the stock, it can transfer a good title to the purchaser of that stock. One kind of case which has repeatedly arisen under this section is concerned with the power of a bank to have a lien on its own stock in the hands of its stockholders;

[1] National Bank Act, June 3, 1864, Rev. Stat. U. S., Sec. 5201.

the courts deny that a national bank has power to acquire such a lien, and hold that any provision of charter or by-laws is void which prohibits a transfer until the liability of the stockholder to the bank is paid. A national bank may loan upon the security of the stocks of other national banks.

2. Loans of Bank Examiners

Banks may not loan to bank examiners.

> No member bank or any officer, director, or employee thereof shall hereafter make any loan or grant any gratuity to any bank examiner. Any bank officer, director, or employee violating this provision shall be deemed guilty of a misdemeanor and shall be imprisoned, or fined, or both. Any examiner accepting a loan or gratuity from any bank examined by him or from an officer, director, or employee thereof shall be deemed guilty of a misdemeanor and shall be imprisoned . . . . or fined . . . or both . . . . and shall forever thereafter be disqualified from holding office as a National Bank examiner.

The purpose of this section is, of course, to guard against the corruption of the national bank examinations.

3. Loans to Officers and Directors

National banks may make loans to their officers and directors as freely as to any other persons; but when such loans are made they must be free from fraud, and the borrowers must not participate in voting the loans to themselves.

4. Limits of Borrower's Liabilities to Bank

The law fixes a limit to the liability of any person to a bank. The amounts which a national bank may properly lend to any one person, company, corporation, or firm (including in the liability of a company or firm the liabilities of the several members, thereof) under the provisions of Section 5200, as last amended, October 22, 1919, are stated below in terms of the percentage of

the paid up and unimpaired capital stock and surplus of the lending bank.

Character of Loans	Amounts Loanable
1. Accommodation or straight loans, whether or not single name.	Maximum limit, 10 per cent of bank's paid-up and unimpaired capital and surplus.
2. "Bills of exchange drawn in good faith against actually existing values." The law expressly provides that this phrase shall also include: (a) Drafts and bills of exchange secured by shipping documents conveying or securing title to goods shipped. (b) Demand obligations, when secured by documents covering commodities in actual process of shipment. (c) Bankers' acceptances of the kinds described in Section 13 of the Federal Reserve Act.	No limit imposed by law.
3. Commercial or business paper (of other makers) actually owned by the person, company, corporation, or firm negotiating the same.	No limit imposed by law.
4. Notes secured by shipping documents, warehouse receipts, or other such documents, conveying, or securing title covering readily marketable non-perishable staples, including livestock. No bank may make any loan under (4), however:	15 per cent of bank's capital and surplus, in addition to the amount allowed under (1); or if the full amount allowed under (1) is not loaned then the amount which may be loaned in the manner described under (4) is increased by the loanable amount not used under (1).

(a) Unless the actual market value of the property securing the obligation is not at any time less than 115 per cent of the face amount of the note. (b) Unless the property is fully covered by insurance, and in no event shall the privilege afforded by (4) be exercised for any one customer for more than 6 months in any consecutive 12 months.	In other words, the amount loaned under (1) must never be more than 10 per cent, but the aggregate of (1) and (4) may equal, but not exceed, 25 per cent.
5. Notes secured by not less than a like face amount of bonds or notes of the United States issued since April 24, 1917, or by certificates of indebtedness of the United States.	10 per cent of bank's capital and surplus, in addition to the amount allowed under (1); or if the full amount allowed under (1) is not loaned, then the amount which may be loaned in the manner described under (5) is increased by the loanable amount not used under (1). In other words, the amount loaned under (1) must never be more than 10 per cent, but the aggregate of (1) and (5) may equal, but not exceed, 20 per cent.
6. Notes secured by United States Government obligations of the kinds described under (5), the face amount of which is at least equal to 105 per cent of the amount of the customer's notes.	No limit; but this privilege under regulations of the Comptroller of the Currency, expired December 31, 1920.

The purpose of this limitation is to avoid a concentration of risks by large loans to one person and to force such a distribution

of risks among many persons that the failure of any one or several of them will not so seriously involve the bank as to endanger its solvency. At the same time, lest the bank's operations be unduly restrained by applying the 10 per cent rule to all discounts, the safer discounts are excepted, namely, "bills of exchange drawn against actually existing values" and "commercial or business paper actually owned by the person negotiating the same"; the limitation extends, therefore, in spirit, to improvident loaning on speculative and accommodation paper, and not to paper used and required in legitimate business transactions.

Determination of Borrower's Liability

In determining the extent of a borrower's total liability many difficulties arise. It would seem that the liabilities of a person to the bank as indorser, guarantor, or surety should not be considered in computing the 10 per cent limit, unless he actually negotiated the loan at the bank and received the proceeds; but the Comptroller has ruled that the liabilities of an accommodation indorser are to be included. If two firms have a common partner the accommodation indorser is responsible for the liabilities of each firm; the Comptroller has consequently ruled that the liability of the common partner is to be considered the liability of each firm and that if the bank loans to one firm to the 10 per cent limit, it is precluded from loaning to the other. If a national bank has branches, it may loan at both the parent and branch banks to one and the same person, but the aggregate of loans by both parent and branches must not at any time exceed 10 per cent of the total capital and surplus of the corporation.

Advances of money by national banks against shipments of grain, cotton, or other products come within the class of loans exempted from the 10 per cent limit, as "discounts of bills of exchange drawn in good faith against actually existing values," if they are made by the discount of drafts drawn by a seller against a buyer, and the respective bills of lading are attached to

the drafts. However, if for any reason it is impracticable to discount such drafts, advances may be made on "commercial or business paper" by banks discounting the notes given in payment for grain, cotton, or other products; instead of making advances of money in excess of the 10 per cent limit to any person for the purchase of these products, the purchasers should be required by the seller to give their notes in payment, which the seller may then discount with the bank indorsing them and tendering together with them the warehouse receipts assigned to the bank; advances made in this manner are within the exemption of the 10 per cent limit. But advances made by a bank on a collateral note secured by warehouse receipts on such products are subject to the limitations of (4), page 926. The Federal Reserve Act provides that "all deposits of a national bank with non-member banks which are in excess of 10 per cent of its capital and surplus are to be reported as excessive loans."

The only penalty for violating the 10 per cent limitation is the liability which the bank incurs of forfeiting its franchise; loans in excess of the 10 per cent limit may be fully recovered from the borrower.

Loans on Real Estate Security

Loans on real estate security are restricted by law.

> Any national banking association may make loans secured by improved and unencumbered farm land situated within its Federal reserve district or within a radius of one hundred miles of the place in which the bank is located, irrespective of district lines, and may also make loans secured by improved and unencumbered real estate located within one hundred miles of the place in which such bank is located, irrespective of district lines; but no loan made upon the security of such farm land shall be for a longer time than five years, and no loan made upon the security of such real estate as distinguished from farm land shall be made for a longer time than one year nor shall the amount of any such loan, whether upon such farm land or upon such real estate,

exceed fifty per centum of the actual value of the property offered as security. Any such bank may make such loans, whether secured by such farm land or such real estate, in an aggregate sum equal to twenty-five per centum of its capital and surplus or to one-third of its time deposits and such banks may continue hereafter to receive time deposits and to pay interest on the same. The Federal Reserve Board shall have power from time to time to add to the list of cities in which National banks shall not be permitted to make loans secured upon real estate in the manner described in this section.

Among the regulations laid down by the board to carry out this section is the following:

In order that real estate loans held by a bank may be readily classified, a statement signed by the officers making a loan and having knowledge of the facts upon which it is based must be attached to each note secured by a first mortgage on the land by which the loan is secured, certifying in detail as of the date of the loan that all of the requirements of law have been duly observed.

The only three cities in which loans on real estate are prohibited to national banks are the central reserve cities, New York, Chicago, and St. Louis; that is, the board up to the present time has not seen fit to extend the prohibition to cities outside these.

Investments in Real Estate and Mortgages

The investments of national banks in real estate and mortgages are also limited by law.

A national banking association may purchase, hold and convey real estate for the following purposes, and no others: First, such as shall be necessary for its immediate accommodation in the transaction of its business. Second, such as shall be mortgaged to it in good faith by way of security for debts previously contracted. Third, such as shall be conveyed to it in satisfaction of debts previously contracted in the course of its dealings. Fourth, such as it shall purchase at sales under judgment, decrees, or mortgages held by the association, or shall purchase to

secure debts due to it. But no association shall hold the possession of any real estate under mortgage, or the title and possession of any real estate purchased to secure any debts due to it, for a longer period than five years.

The authority conferred in the "Second," "Third," and "Fourth" of the foregoing quotation is to enable a bank to collect debts due it. A bank wishing to acquire any interest in real estate, except for a place of business, or any mortgage or lien on real estate, can do so only upon a debt previously contracted in good faith; it has no power to deal in real estate, or (except within the limitations set by the law quoted) to take real estate or any mortgage or lien thereon as security for contemporaneous loans; it has no right to take a mortgage to secure a note discounted at the same time, or to secure paper to be discounted later, or to enter into an agreement at the time of discounting that it will take a conveyance of real estate in payment or satisfaction of the note. The United States Supreme Court declared that the spirit and intent of the prohibition of concurrent loans on real estate security is the prevention of hazardous investments by the bank, the keeping of money in the regular channels of business, and the prevention of accumulation of masses of real estate in the bank's hands. It has been held by the Iowa court that a national bank may make an agreement that, in case a note discounted by it shall not be paid, a mortgage given by the maker to his indorser shall inure to the benefit of the bank. That is, the mortgage of real estate to a third party, to be held by the mortgagee in trust to secure a loan made by a national bank, is a valid transaction, and the bank can, by proceedings in equity, reach and avail itself of the security. In interpreting what is and what is not within the inhibition against loans on real estate, very nice decisions are often necessary. One, for example, is whether the debentures of mortage loan companies can be taken as collateral; the Comptroller has ruled that such debentures are not proper securities for national banks to receive.

The reason for the limitations on bank loans on real estate is that since the liabilities of a commercial bank are demand liabilities, its assets must for safety be quickly convertible into money, and while a mortgage upon real estate may be a good and sufficient security it cannot be made immediately available, the market for this sort of security being poorly organized and the liquidation of any interest in real estate always attended with delay. If a commercial bank invests too large a proportion of its funds in real estate securities on which it is impossible to realize quickly when needed, suspension is inevitable. On the other hand, savings banks, trust companies, insurance companies, and other financial institutions whose liabilities are time rather than demand liabilities, find real estate loans well adapted to their needs. The danger of this kind of loan can be reduced by restriction as to total volume, margin, location of the securing real estate, period of loan, and ratio to time deposits. The more rigid restrictions of the national banking laws were tempered in the Federal Reserve Act along these lines, as previously shown, as it was felt that the national banks were not serving the community as they might. One result of the rigid restrictions was the rapid extension of state banks because of their greater freedom in real estate loans. To put the national and state banks on a fairer competitive basis and to remove an obstacle to the entry of state banks into the federal reserve system, reasonable modifications of the law were made. At the same time the federal farm loan system was devised to provide long-term loans, that is, loans longer than five years, on real estate.

Usury Laws

The National Bank Act provides that any national bank may charge, on any loan or discount made, or upon any note, bill of exchange, or other evidences of debt, interest at the rate allowed by the state where the bank is located, and no more. When no rate is fixed by the state, the bank may charge a rate not exceed-

ing 7 per cent per annum, and such interest may be taken in advance, reckoning the days for which the instrument of debt has to run. And the purchase, discount, or sale of a bona fide bill of exchange, payable at a place other than the place of such purchase, discount, or sale, at not more than the current rate of exchange for sight drafts in addition to the interest, is not considered as taking a greater rate of interest. Taking or charging a rate of interest greater than is allowable by law, when knowingly done, is deemed a forfeiture of the entire interest which the instrument of debt carries with it or which it has been agreed shall be paid thereon. In case the greater rate of interest has been paid, the payor by an action of debt may recover twice the amount of the interest thus paid, from the bank receiving it. Such action must be begun within two years from date of payment.

The usury laws of the various states differ as to the maximum rate of interest allowable, the loans to which it applies, the penalty, etc. The maximum rate is usually 6 or 8 per cent. New York exempts collateral call loans in amounts of $5,000 or above from the inhibitions of the usury law.

The consequence of taking or stipulating for usurious interest is to destroy the interest-bearing power of the obligation forever, and the taint survives through all transformations and renewals, so long as the obligor remains the same. But the instrument itself is not void. The bank may sue on it, and the surety is bound to the same extent as the maker. The principal can be recovered, but no more, and any interest that has been paid can be applied on the principal.

There has been much dispute as to whether a bank can "purchase" negotiable paper, and whether, if it can, such purchases are subject to the usury law. If it can purchase paper free from the restraints of the usury law, a means of evasion of that law is thereby provided. If A gives money to B on B's note in favor of A, it is a loan and not a purchase, and is subject to the usury law. But if A transfers B's note to C by indorsement, so that A be-

comes bound on it, the question is whether it is a sale or a loan subject to usury. The most common interpretation is that it is not a loan, because C cannot claim the money from A unconditionally, but must use due diligence in pursuing B, and the risk and expense involved in such pursuit is an important consideration, in addition to what occurs in a loan, and may well be taken into account in the price paid by C. And if A transfers B's note to C by delivery only, or by indorsement without recourse, this is a sale, and may be for any price agreed upon by A and C. If it is apparent that the above transfers are mere cloaks to cover usury, the courts would not allow the evasion. It appears from decisions that banks have power to purchase paper at any agreed price, but all transfers of negotiable paper to a bank are subject to the usury laws, and the bank has no power to take the paper at a greater reduction. It may not take more than the legal rate of interest, but it may discount, that is, take out that interest at the time it pays the proceeds to the borrower.

Usury laws are ancient. In Biblical and medieval times they aimed at relieving the poor from the exactions of the money-lender. Pay for the use of money was either prohibited or limited to such rate as the laws of nature were held to warrant. Such laws now are no longer useful or effective. High interest rates serve to discourage borrowing and promote saving, and therefore cure themselves. Usury laws are easily evaded by many ingenious devices, and many states have repealed their usury laws. It is likely that extortion by lenders could be adequately remedied by the simple rule that applies to all contracts, namely, that gross inadequacy of consideration is evidence of fraud.

CHAPTER XLVII

THE CREDIT DEPARTMENT

General Functions of the Credit Department

When an application is made for a loan or discount the banker must decide: (1) upon the desirability of the applicant as a customer of the bank, (2) upon the probable willingness and ability of the applicant to repay according to the terms agreed upon, and (3) upon the security or protection which the applicant offers the bank against default. Certain applicants are favorably received because it is believed that they will not only add to the profits but also to the prestige of the bank; others are refused because of their bad financial records and business reputations. A bank which specializes in, say, cattle loans may refuse applications for cereal loans. Many factors, such as character, reputation, line of business, domicile, etc., determine the banker's attitude toward the applicant. The question of willingness and ability to repay depend upon the business ability, integrity, and capital of the applicant, the nature and possibilities of his line of business, and the special conditions attending the ventures in which he is engaged. If he offers commercial paper for discount, the same information must be known about the makers of those instruments as about himself. To assemble information of this sort and put it into useful form the banker employs a credit department.

With respect to security, loans are of two sorts, unsecured and secured or collateral. Unsecured loans are made on the mere written promise of the borrower to repay at maturity. Such promises have value in proportion to his character, capital, and capacity—the three C's of credits. Data for estimating these elements are assembled and digested by the credit department,

and the final estimates of them are made by the proper officers of the bank.

Promises to repay may be reinforced by pledges of value, the right to which passes to the creditor upon default of the borrower to repay according to the agreed terms of the promise. Loans evidenced by a contract secured by pledged property are called "collateral" loans. The pledged article may be: (1) actual wealth, as jewels, or (2) titles to wealth, as warehouse receipts, or (3) credits, as bonds or commercial papers. The problem of the bank in the case of collateral loans is less an estimation of the character, capital, and capacity of the borrower and more an estimation of the value of the securities pledged; but the credit of the borrower is carefully weighed before loans are extended even on collateral, the first essential when a man borrows money or seeks credit being a good business character. If the collateral consists of commercial paper, the names of the makers and indorsers upon this paper must be as carefully investigated as are those of borrowers on unsecured notes.

Need for Credit Department

The credit department is a necessary part of bank organization when the bank's business extends beyond the known local community. In banks doing a local business only, the officers are chosen with a view to their intimate knowledge of the financial conditions and business relations of their fellow-townsmen; it is quite possible for the officers to know local conditions and borrowers well enough to protect the bank. It is also possible for the local bank to depend upon the credit service of its metropolitan correspondent. But the expansion of banking operations from a local to a regional or national sphere has necessitated the assembling and classifying of credit information for the district covered. The very size of the bank and its field of operations has created a need for more credit information than any group of officers could personally acquire and retain in their heads, and hence a bureau

to gather, classify, digest, and make useful such information has become indispensable.

The credit department, as it is now understood, is a recent development in banking. Such departments were first organized about 1890; they started in New York, and up to 1900 were confined to that city. After 1900 they spread to the other large cities quite rapidly. The volume and importance of their work also increased, and they now pursue more scientific and complete methods in the assembly and analysis of credit data. The requiring of financial statements from borrowers, by which the bank might estimate the credit of the borrower, arose during the years of recovery from the panic of 1893, and the intervening years have not altogether eradicated the idea that a request for such a statement reflects on the borrower's credit. Gradually, however, borrowers are learning that co-operation with their bank's credit department is a wise business policy, and the credit department is fast becoming one of the most important divisions of the bank.

Effect of Federal Reserve System on Credit Department

The commercial paper market has developed coincidently with the credit department, their growths having been to a large degree the result of their reciprocal action on each other. Both also have been fostered by the development of nationally known commercial houses, great industrial corporations, a better articulated business system, and foreign commerce. To be able to take advantage of offers of commercial paper by note-brokers the banks found it profitable to maintain a well-organized credit department, that bank which could decide first and most accurately upon the advisability of buying paper at such and such rates thereby acquiring an important advantage over other banks less informed. The federal reserve system will especially promote the credit department. The Federal Reserve Board and banks have laid emphasis on financial statements and credit files. The Federal Reserve Act and the regulations of the board require the

member bank to provide financial statements from most names on paper offered for rediscount, and have furnished standard forms for such statements. Under the old system national banks recommended themselves to their out-of-town correspondent banks by their collection facilities; but the par collections system tends to reduce these facilities to a common level. Hereafter one of the chief services of reserve city correspondents will be the credit service; and the credit department will not only pay its way by keeping losses at a minimum but will become a holder and builder of business. The credit department's usefulness will also develop as the attitude of the borrowing public becomes one of co-operation, so that it will be provided with exact, full, and honest data from which correct judgments can be drawn and maximum credit can be extended on the basis of the showing.

Summary of Departmental Work

The work of the department may be summarized as follows:

1. The collection of information of every kind regarding banks, individuals, manufacturers, and mercantile houses, particularly those who may become customers of the bank, those who sell their commercial paper to the bank through note-brokers, and those with whom the bank does foreign exchange business.
2. The analysis, classification, and filing of this information for the various uses to which it will be put.
3. The conduct of all correspondence by letter or telegram pertaining to the payment or non-payment of discounted notes or the substitution of receivables.
4. The monthly examination of the average balances of all accounts with the bank and, if there are material changes noted, the requisition of reports on those balances from the analysis department; and the preparation of statements of average balances of all accounts for the bank officers.

5. Furnishing credit information to other local banks, to correspondent banks, to customers, and to other departments of the bank, upon request.
6. The selection and purchase of commercial paper for customers, at their request.

The credit man must have a high order of ability. He must have a wide knowledge of men and of business, and his fund of information on the methods of business in the various lines must be large and varied. He must be an accountant, with rare power to analyze accounts and financial statements. He must be versed in commercial law in general and the statutory commercial law of the various states in particular. He must be a born observer and judge of men and business conditions. As he meets personally many prospective customers he has the best opportunity to draw direct conclusions regarding their personal and business characteristics and abilities; these judgments must ever be conservative. He must be systematic, keeping his credit files full and up to date lest they be used as the basis of wrong conclusions. While the final determination of whether or not the loan is to be granted devolves upon the higher officers of the bank, the credit man's findings, interpretation of the facts, analyses of financial statements, and estimates of character and of ability weigh heavily with the officer who makes the ultimate decision.

Internal Organization of the Credit Department

The division of labor and the plan of administration in the credit department are, of course, arranged with the object of efficiency and vary with the individual bank. They must coordinate with the general scheme of administration of the bank and at the same time be so framed as to facilitate the collection of data. Taking, by way of illustration, a national bank doing both a foreign and a domestic business, the following organization may be suggested. The department is divided into three sections: the bank section, the domestic section, and the foreign

section. The bank section takes care of investigations of banks; the domestic section investigates the individual and commercial accounts and names in the United States and Canada; and the foreign section investigates the foreign exchange accounts, accounts in the bank's branches, if it has branches, and names in all parts of the world.

The domestic section may be divided into a number of subsections according to federal reserve districts. For instance, these districts may be grouped as follows: districts 1 and 2, districts 3 and 4, districts 5 and 6, districts 7 and 9, districts 8 and 11, districts 10 and 12. This grouping serves to equalize the work as between subsections and to put together areas on the basis of characteristic industries, and at the same time conforms to the general banking system scheme. These subsections will handle all the business from their areas, except, say, commercial paper names and miscellaneous inquiries, for the handling of which two special subsections may be found expedient. Each subsection will be under the immediate supervision of a head, with one or more assistant heads, and the subordinate clerical force of each subsection consists of junior clerks, stenographers, typewriters, etc. Several officers of the bank may be delegated to each subsection, and they determine and pass upon all credit matters pertaining to their areas.

Credit investigations of names outside the bank's home city are made by mail. Occasionally, in special cases, the bank may get the assistance of its branch offices in other cities to investigate a name, or it may send a traveling credit investigator into an area. But the investigation of names in the home city is done by credit investigators, in addition to investigation by mail and telephone. If, for example, the bank is located in Federal Reserve District Number 2, the subsection (of the domestic section) of which this district is a part will have segregated in it a group of credit investigators and will have a special assistant in charge of them. There will be, say, a dozen of these investigators, ten of

whom may each handle all names in the flour, feed, grain, hay, fruits, vegetable, produce, poultry, and meat trades; another may handle all the names in the clay products, glass, glassware, tableware, bottles, woodenware, diamonds, watches, and jewelry trades, etc. The other two investigators may be special men whom the chief may send into any trade on special investigations as occasion may require.

Passing upon Loans and Discounts

When an application for a loan or discount is made by a prospective account, an investigation is instituted by the credit department through personal interviews with banks with which the applicant has been doing business and through trade circles and any other channels that may present themselves. When the applicant is a customer or correspondent bank, a statement is made up by the various departments, showing the name of the applicant, the amount of accommodation requested, the highest amount of credit given last year, amounts now loaned or under discount, the amount of credit outstanding with the foreign division and the maturing dates, the average balance for recent months and the corresponding balance last year, and the present balance.

The credit information, together with the "offerings" and the letter requesting the loan, is submitted to the proper bank officers who in such a bank as that described above would be the officers in charge of the territory in which the borrower is located. Certain banks have a special discount committee, variously composed of directors, officers, and department heads; in smaller banks the board of directors may pass upon the loans and discounts individually. The offerings may be submitted formally upon offering slips or in an offering book in which the offerings are entered. The loans and discounts are usually passed upon by a proper officer and approved later by the discount committee by attesting the offering book or discount register, or by formal vote of the

board of directors, made part of their permanent records. The ultimate responsibility for all loans and discounts rests upon the board of directors. The bank extends to the applicant what is called a "line of credit" or a specific loan or agrees to discount or purchase certain paper.

To Whom Credit Information Is Furnished

The credit information is, of course, for the use of any department or officer of the bank needing it. One of the functions of the credit department is the daily clippings service. Every man in the department may be required to read a different morning paper and items of credit interest are marked and clipped. Particular attention is given to the death and obituary column, business embarrassments, judgments, financial notes, changes in firms or corporations, and changes in the amount of capital and surplus carried. If the death of a customer is published, notice is sent to such departments as the check desk bookkeeper, paying teller, certification, signature, loan, customers' securities, discount, and auditor; and the item is filed in the customer's credit record.

Letters of inquiry on commercial paper names and on various other credit matters are received from customers and other banks, and are answered by letter or telegram, as requested. If the department has no file for the particular party named, a credit investigation is started and the customer advised that he will be informed fully upon completion of the investigation. These letters of inquiry often contain requests for information on a score or even a hundred names; less detailed reports are made to such letters. The miscellaneous inquiries are on a wide variety of subjects and often cause considerable trouble and expense in obtaining the required information. The bank may not charge for this service of answering inquiries unless it has to employ the services of a special bureau or obtain information by telegraph or cable, and then it may charge only the additional expense.

Occasionally the credit department is requested by an out-of-

town correspondent to purchase paper for their account, paper bearing either a name of their own selection or one to be selected by the department. The department usually selects the notes of a customer of the bank when it is asked to make the selection. Frequently, also, the department is asked by correspondents to obtain lists of offerings for them from note-brokers, and to signify its approval of such offerings by checking on the lists the names which it considers good; the lists are then forwarded to the correspondents and they make the final selection and buy by direct order to the broker.

All letters giving information are written on non-liability paper, on which is printed some such statement as the following:

> All persons are informed that any statement on the part of this bank or any of its officers, as to the responsibility or standing of any person, firm, or corporation, or as to the value of any security, is a mere written opinion, and given as such, and solely as a matter of courtesy, and for which no responsibility, in any way, is to attach to this bank or any of its officers.

Since these letters are important, however, as being the pronouncement of a big bank upon the credit of a party, great care is taken as to their contents and despatch. In answering credit inquiries by telephone greater caution is necessary than in answering those by mail.

The bank seeks to establish and maintain friendly relations with other banks in its city and to have a relatively free interchange of credit information. All day long investigators from other banks and commercial houses call to make inquiry, generally about customers, but sometimes on commercial paper names.

Credit Files

To make the credit data really serviceable a correct and intelligent filing system is very important. A common division of a bank's credit files is into:

1. Customers, embracing:
    (a) Banks—correspondents and non-correspondents
    (b) Individuals
    (c) Commercial paper names
    (d) Foreign exchange names
2. Miscellaneous—persons and firms with whom the bank has no dealing

The number of credit information folders of a large bank reaches into the thousands.

The filing system of a certain bank is as follows: The filing cases are steel and the vertical system is used. The credit information is filed in a special folder, which for convenience is divided into sections:

1. The front sheet, on which are entered the name, address, how introduced, line of accommodation granted, broker handling the paper, names of indorsers, if any, and other bank accounts.
2. Discount tickets, in which section all offering tickets are filed.
3. Information, in which are filed the results of the credit investigations. In order to conserve space and obtain uniformity and compactness all information received from any source is extracted and placed in this section, the source being indicated by a color scheme; newspaper clippings, letters direct from the concern giving information relative to the business, and officers' memoranda, are properly filed away here, all according to date.
4. Statements, which include the recapitulation sheet, the comparative statement form, and the original statement, if received direct or through a broker.
5. Inquiries, which embrace all copies of letters in reply to inquiries concerning the subject, or, in the case of the more active names, a memorandum sheet giving the

date of inquiry, from whom, date of reply, and form of letter written.

6. Agencies, being a file of the agency reports, one from each mercantile agency.
7. Correspondence, covering all correspondence direct with the bank except that containing information as above specified.

All of the folders are equipped with tabs, on which are entered the names and addresses of the parties concerned, which, when in the files, constitute an alphabetical index. A slightly different folder is used for names other than those of customers.

Certain auxiliary files are also kept: one for answered letters of inquiry, one for letters of acknowledgment and letters from which information has been extracted, one for letters of introduction, one for envelopes in which financial statements are received direct from the subject concern, and one for old information.

The files are rendered still more useful by separate card indexes. An index, by states and cities, of all borrowing accounts, and foreign exchange and commercial paper names, is handy in making up a list of names in which the bank is interested in any particular state or city. Useful also is an index of all the commercial paper names which the bank buys; this is a record of the amount of paper bought, date of purchase, date of maturity, date of last investigation, and date of latest statement received.

It is very important to keep strictly up to date the records:

1. Of borrowing customers.
2. Of houses whose commercial paper the bank buys through note-brokers or otherwise.
3. Of concerns with which the bank has foreign exchange dealings, either direct or through open-market purchases.

All information on such parties is revised once a year, or more often, as the case may require. Non-borrowing accounts, except

such as sell their paper on the open market, need not be followed as closely as borrowing accounts. The foreign exchange names are investigated very closely; if need be, a special representative may be sent to make direct personal inquiries in, say, the cotton belt at certain seasons if the bank is buying cotton bills freely. Commercial paper names are investigated periodically, after receipt of their new financial statement, and sometimes more frequently; and names which do not make statements are commonly investigated two or three times a year.

The preliminary work in the procuring of new customers will ordinarily be done by the bank officer in charge of the area where the prospective customer lives, but sometimes banks allot such work to a special department known as a "new business" department. The officer or the new business department, as the case may be, submits to the credit department names of prospective accounts. Such names are immediately placed under investigation, if the information on them at hand is not already up to date, and upon the basis of the information collected the credit department decides whether the candidate would make a desirable customer or not and recommends accordingly.

Sources of Credit Information

The credit men of banks and of commercial houses use much the same sources of credit information and the same methods of procuring it. In general the commercial houses are less exacting and accept higher risks; they also have special interests to serve which banks do not have; their credit extensions are mostly in their own line of trade, whereas banks cover all lines; and they can use their traveling salesmen as credit reporters, arrange credit interchange bureaus within their state or national trade organizations, and employ certain other facilities, from all of which banks are excluded. For these and other reasons it seems best to consider primarily the credit sources and methods used by bank credit men. The more numerous the sources of information used the more

reliable are the conclusions that may be drawn, since one source acts as a check on the others; hence, every class of views it is possible to obtain should be consulted and the investigations diversified accordingly.

1. Interviews with Borrowers

The most fundamental and important source of data is the borrower himself, expressed in a personal interview and a financial statement. An interview gives the borrower opportunity to convince the credit man that he possesses character, business ability, and a knowledge of his line of business, and is therefore entitled to credit; he may also in confidence explain away certain apprehensions which the credit man has toward him. On the other hand, the credit man is given opportunity to ascertain and estimate the applicant's character, business capacities, and methods, and to inquire closely into any doubtful feature.

The applicant should visit the bank credit man in person. But it is equally common for the bank credit man or his personal representative, a credit investigator, to visit the applicant in his place of business; he goes loaded with all the credit information procurable from other sources, and tactfully lets the applicant explain away any doubt upon his title to credit. How searching this interview may be depends upon whether the line of credit considered is abnormal and whether any serious weaknesses are disclosed. The interview may become an inquisition, and the credit man make a thorough examination of the books, accounting, organization, and management of the applicant concern.

Utility of Financial Statements

When a person applies to a bank to open an account and establish the regular relations of borrower and depositor he understands that the bank will ask him to submit a statement of his affairs and that the bank will make a credit investigation. Business policy requires not only that the bank guard itself against

losses from bad loans but also that it defend its good name by keeping a good personnel of customers.

The practice of asking and requiring financial statements from customers originated only a generation ago, and the spread of the practice is a notable fact of recent banking history. It is no longer considered a mere technical and bothersome imposition on applicant borrowers; nor is it regarded sound practice to compete for customers by showing leniency in this matter. The American Bankers' Association, the various state bankers' associations, the National Association of Credit Men, the federal reserve banks, certain clearing houses, and most of the large banks, have prepared statement forms for applicant banks, corporations, firms, and individuals, and have urged their use in determining credit title.

For an applicant to refuse to tender a full statement or to do it reluctantly or to omit certain vital data has come to create a suspicion, and may induce the bank either to refuse credit entirely or to offer a more limited line. It is also important that the statement be prepared in a businesslike manner, for the style, completeness, and precision of the statement are bound to impress the credit man with the applicant's business capacity and careful methods of bookkeeping, or their opposites.

Financial statements provide excellent comparative data to judge a firm's growth, drift, and possibilities and its rank among competitors. These statements will become more and more useful as uniform accounting methods are adopted in any trade, and numerous factors at present are tending to bring this uniformity about. As yet banks find it necessary to reduce the various financial statements to comparative statement forms, and if any information is needed on the form besides that on the financial statement, it is gathered by special investigation.

The applicant borrower is also benefited by the requirement that he prepare and submit to his bank a financial statement. It necessitates better and more careful accounting, and this helps

him manage his business more efficiently, for he knows the details, discovers sources of losses that would otherwise be hidden, and aligns himself with modern accounting theory and practice. The bank's credit man checks up his reports, gives suggestions and correctives, and thus serves as a sort of auditor for him. The banker is in position to advise him in the financial conduct of his business, which otherwise he would not be, for fulness and accuracy of data are prerequisite to sound advice. The banker, knowing intimately his customer's business and having advised about its conduct, is more likely to feel the obligation of supporting him in need. The banker is in a position to advise others authoritatively about his customer's credit. The customer is likely to be more conservative in his ventures when he knows that his banker will insist upon reviewing his operations.

2. Mercantile Agencies—Organization

A second source of credit information is the mercantile agency. A mercantile agency is an organization whose business it is to ascertain the credit position of banks, corporations, firms, and individuals and to circulate this information among its members and subscribers. These agencies are of two classes: the special agency, which limits its field of operations to one or a few lines of trade, as textiles, furniture, and the like, and the general agency, which covers approximately all lines and has a large and comprehensive organization. Mercantile agencies are the most universally used and probably the most influential source in the credit world in general. The most important general agencies are Dun's, Bradstreet's, Ellis', and Seyd's. Some of the special agencies are the Jewelers' Board of Trade, the Leather Trade, Special Reporting Company, Best's Insurance Reference Books, and Bishop's.

The organization of the general agency is built to conserve time in reporting, to adapt itself to local conditions, and to be permanent. The country is divided into districts, each district com-

prising a few counties and having a central office at which the data are assembled and transmitted to the main offices. Branch offices are established in foreign countries and in our territorial possessions. Each district office has traveling reporters who cover their respective territories, call upon merchants and other business houses, procure financial statements, references, etc. These references and others are consulted, and the figures on the statements are verified if possible. Local correspondents are engaged everywhere, who report on new mercantile or other houses set up, on items that may affect the credit standing of the old merchants, on lawsuits, mortgages, and deeds recorded, etc., which might affect credit titles. The local correspondents and the traveling reporters act as checks upon each other. The reporters become experts along certain lines, and in larger cities some are delegated to follow one trade or kindred trades alone, others to report on conditions in the financial districts as found by circulating among banks.

Services of Mercantile Agency

The agency sells its service to subscribers for a period of years. The service takes several lines but primarily consists of: (1) reports on certain parties about whom the subscriber makes inquiry, and (2) ratings of capital and credit of practically every business concern in the country. After an inquiry is made by a subscriber about a certain person, the agency makes an initial report and follows it with advices about news of bankruptcy, assignments, foreclosures, lawsuits, suspicious transfers, pledging of accounts receivable, mortgages given, securities issued, and fires and serious losses that may affect the credit title of the subject.

The reports are inclusive and cover the history of the firm and of its officers; the names of its officers and directors; summaries of previous financial statements; full details of the latest statements, with comments and criticisms by the agency; the character,

habits, and business capacity of the concern and its officials; comments on the place of business, its equipment, location, business outlook; credit standing, the opinions of other houses of the trade dealing with the subject concern as to the subject's manner of payment, his punctuality, etc.

The ratings are very condensed conclusions as to the capital and net worth of the party, after deductions for depreciation, etc., and as to the grade of credit title of the party as reflected by his past record, business ability, and business prospects. These ratings are published quarterly in books which are loaned to subscribers; the names are arranged by states, cities, or other municipal districts, and alphabetically; the ratings are given for about two million names, and, to save space and serve convenience, are given in symbols.

The ratings of Dun's, Bradstreet's, and other commercial agencies are rather to be considered as indexes to the contents of the reports and cannot be trusted exclusively. They are subject to frequent revision, and the bank credit man's analysis and estimate of the credit data may differ radically from that of the agency's opinion. The ratings are useful as checks and comparisons; the change of an agency rating may suggest a reinvestigation of the name; and they serve, in case the department has no other data, in cases where information is desired quickly.

Whereas the general agency aims at comprehensiveness, covering the world and all lines, it is necessarily slower in getting out reports and bringing them up to date and is more expensive than special agencies organized to render special services, in a few lines of industry, over a more limited territory. These special agencies vary so widely in their activities that it is beyond the compass of this chapter to describe them.

3. Interchange of Credit Experience

A third source of credit information is the direct interchange of credit experience with a common customer between members

of the trade, and between members of the trade and the bank, and between the banks. The bank credit man is interested only in the latter two. Credit interchange is one feature of the larger business movement in co-operative competition, and when fully adopted gives credit information of a most thorough and excellent kind, and by it undesirable customers in banking and commercial lines can be most effectively eliminated.

Credits extended by the bank bear an intimate relation to credits extended to and by the merchant or manufacturer; where a merchant procures credit from both the bank and the trade, if his credit standing is impaired at either, the other is adversely affected. For this reason the bank is anxious to know whether its customers are maintaining good credit reputations in their trade, and to this end frankly asks members of the trade who have dealings with the bank's customers for their ledger experiences and opinions regarding those customers. On the other hand, the members of the trade appreciate knowing the standing of the customers at the bank.

Usually the information given by the trade to banks is fuller and franker than that given by banks to the trade. Banks are very reluctant to disclose detailed credit information about their customers. Banks argue that since they work on a very narrow margin of profit and lend in larger amounts and to fewer members of the trade than is common among members of the trade itself, and lend both their own and their customers' funds, it is necessary that they safeguard themselves more than members of the trade must; accordingly they enter into very confidential relations with their borrowers and have private information, to communicate which would be a violation of confidence. Moreover, they contend that they take precautions by way of collateral guaranty and indorsement as security, which facts would be misunderstood by the outside trade to mean that the bank regarded the customer as a bad credit risk.

The banks are tending, however, to interchange credit data

with the trade more freely and fully, particularly as between their own customers. The banks are also tending to interchange data with one another more freely and fully, but not to the degree that is done between members of a trade.

4. Credit Exchange Bureaus

In addition to replies to direct queries about a member of the trade, the trades have organized credit exchange bureaus to facilitate the interchange of credit information among their respective members. The local credit men in a city or other area often establish such bureaus; the various groups (members of a trade or kindred trades) of the National Association of Credit Men operate such interchange bureaus; but the most of them are operated by the trade associations.

The methods employed by these bureaus vary widely, but the principle is that through co-operation greater economy of expense and completeness of information may be attained. The bureau acts as a clearing house of information and is not intended to supplant but to supplement direct interchange between members. The bureau may report to a requesting member all information which passes through it pertaining to a list of members who are his customers; hence, it reaches its maximum utility and efficiency when it includes in its membership all the possible creditors of a member, that is, when it includes the whole trade. Most of these bureaus are local; the *Credit Monthly* of the National Association of Credit Men lists 54 interchange bureaus (September, 1920) conducted by local credit men's associations, most of which participate in the Central Credit Interchange Bureau, located in St. Louis and established in 1916. The only other institution which attempts to clear credit information on a national basis is the Credit Clearing House which assembles and distributes ledger information as between its half-million retailer members.

There is no interchange bureau in operation among the banks; their only interchange is the direct interchange by letter or

through a personal investigator. Banks seek to establish friendly relations with other banks in their city to the end of freer reciprocation in granting credit information, and they reciprocate with their correspondent banks. Credit men from some 219 banks in the United States are members of the Robert Morris Club, affiliated with the National Association of Credit Men, and they probably represent the most advanced order of credit man.

At a meeting in 1916, on the subject of credit interchange among themselves, this club proposed the following eight rules:

1. That the first and cardinal principle of credit investigation is the sacredness of the replies, and any violation of this principle places the violator beyond the pale of consideration of the honest credit man.
2. That every letter of inquiry should indicate in some definite and conspicuous manner the object of that inquiry.
3. That when more than one inquiry on the same subject is simultaneously sent to the banks in the same city, the fact should be plainly set forth in the inquiries.
4. That individual consideration, by the recipient of a credit inquiry, of the distinguishing marks therein will increase the efficiency of credit investigation.
5. That indiscriminate revision of files regardless of the presence of the name's note in the market is unnecessary, wasteful, and undesirable.
6. That the continued observance of high ethical principles in the conduct of credit departments of banks and banking institutions insures the best results and cooperation in safeguarding banking credits.
7. That it is not permissible nor the part of good faith in soliciting accounts from a competitor to seek information from the competitor without frankly stating the object of the inquiry.

8. That in answering inquiries it is advisable to disclose all material facts bearing on the credit of the borrower to the end that the paper offered in the open market be of the same description as that held by the borrower's own bank.

5. Other Sources of Information

The bank credit man makes use of various odds and ends of information to complete and check his data. The bank subscribes to the leading newspapers and the financial and commercial publications. The columns containing business troubles, legal judgments, changes in the affairs of firms, corporations, and banks, and mercantile, financial, and crop conditions, are carefully scanned, clipped, and filed. Trade reference books facilitate the routing of credit investigations and also contain much useful information. The "Textile Trade Directory," for example, contains a list of all cotton goods and woolen goods manufacturers of the country, and gives a brief description of the mill property of each, the names of the president, treasurer, manager, and selling agent, a list of houses handling the various raw materials consumed by the manufacturers, and a list of all the wholesale dry goods and jobbing houses. The "Fertilizer Trade Handbook" gives not only the names of all concerns engaged in the manufacture of fertilizers, but also those which manufacture cottonseed oil and the houses handling supplies used by these manufacturers. The "Cotton Shipper's Handbook" lists by states and cities all the cotton exporters of this country.

CHAPTER XLVIII

THE FINANCIAL STATEMENT AS A SOURCE OF CREDIT INFORMATION

The Nature of a Financial Statement

A financial statement is a tabular display of the assets and liabilities of a person, firm, association, or corporation, the assets and liabilities being itemized, in more or less detail, according to the subject's bookkeeping methods and its willingness to give the outsider knowledge of its real condition. It should be accompanied by a profit and loss statement, covering its progress over a period of time, and statistics as to annual sales, turnover, profits and dividends, insurance, etc.

The statements are usually prepared by the borrower, and are supplemented and corroborated, if it is thought advisable, by evidence gleaned from independent and indirect sources by the credit department.

In many instances it is necessary to require a borrower to furnish an audited statement. The preparation or proof of a statement by an outside auditor lessens the danger of fabricated statements, but such a course is too expensive and bothersome for small loans. Strong institutions, which run their affairs in an open way and which wish to borrow freely, submit readily to the independent audit of their accounts, but small secretive concerns balk at the idea.

An audit or examination by a credit man is often very beneficial to the borrower. The manner in which the statement is made up indicates largely the methods employed by the concern making it. Some statements are full and explicit, while others are garbled and ambiguous. The latter sort causes suspicion that slipshod methods are in use or that important facts are being

concealed. Concealed facts are brought to light by analysis, and skill in reading between the lines is an essential attribute of the credit dispenser. Men sometimes lead themselves to believe that they are worth more than they really are, but the credit man or auditor, having no personal interest in the affairs of the maker of the statement, is able to view the proposition in an unbiased manner and scale the figures to a point which may closely represent a man's actual worth. An analysis will sometimes lead to the discovery of conditions which it is well for the borrower to know. Men may make an incorrect statement with no intention to deceive anyone, but the lack of knowledge of important business customs can be remedied by co-operation.

The banker also finds the audit of statements necessary, not because he questions the honesty of the borrower, but because of the latter's bookkeeping methods, as his manner of making inventories, valuing his accounts receivable, etc., makes it difficult to get a correct impression of the borrower's condition. The audit even may not be sufficiently thorough to show the exact condition. To be complete, the accounts should be checked very closely. More and wider physical tests should be made of the inventories; particularly in manufacturing concerns should a close check be kept on materials, raw and in process, and an appraisal of the company's plant, machinery, fixtures, etc., made by an appraising company of recognized standing.

The custom of making a statement when a concern's indebtedness is at its lowest point has become quite common, especially with establishments which sell their paper through note-brokers. While in some respects this is all right, in certain others it is manifestly unfair. It often occurs that shortly after a statement of this kind is made, a concern will issue a large amount of paper and incur liabilities for merchandise, thus increasing its total liabilities to such an extent that they almost equal the quick assets. The practice of making statements at the time of low liabilities is followed in many instances in order to make an at-

tractive statement, the ability to clean up liabilities or liquidate to a low point being thereby implied. But it would be far more satisfactory to the credit dispenser if statements were made at the time when the indebtedness is at its maximum as well as when it is at its minimum. In practically every failure of a concern which has sold its paper in the open market it is found that its statements have been timed to periods of low indebtedness. Many concerns have no desire to make a statement at this time of low ebb, but will make it at any time of the year suitable to the convenience of their business. Others prefer to make a statement when their debts are at a maximum, in order to deceive no one.

The more complete the statement the better and more perfect analysis of a given condition can be made. The more the statement is proved by corroborating evidence and an independent audit the surer the conclusions that may be drawn. The more recent the statement the less the possibility of dangerous changes in the character or amount of assets and liabilities. And the greater the number of statements, that is, the more the borrower's history is shown, the greater the value of the statement, since it gives knowledge of the tendencies of the business and its management and policies.

Classification of Assets and Liabilities

The assets of a borrower are classified as quick, or current, assets, and slow, or fixed, assets. Current assets consist of cash, accounts receivable, bills receivable, merchandise, goods in process, raw material, and supplies. The slow assets comprise real estate, plant and equipment, machinery and fixtures, goodwill, patents, delivery equipment, investments in other concerns or subsidiary companies, treasury stock, and deferred assets, such as interest and insurance paid in advance, organization expenses, and discounts on bonds.

Liabilities are similarly classified. Current liabilities include accounts payable, notes payable, amounts due to officers and

stockholders for money lent, wages, interest, and other expenditures. Fixed liabilities are its bonded indebtedness and the mortgages on its real estate or plant. A third class of liabilities considered by credit men is contingent liabilities, which include bills receivable which have been sold and accommodation indorsements. Neither of these liabilities is likely to be presented for payment provided the discounts are self-liquidating and drawn by strong makers and provided the company has not been too free in lending its good name by indorsements.

Ratio of Current Assets to Current Liabilities

In analyzing a statement with a view to extending unsecured credit, greatest consideration is given to those assets which are quick, or quite readily convertible into cash in the ordinary course of business, and to the liabilities which are current, or whose maturities are turning daily. The purpose of the classification is to provide a margin of assets which will guarantee the continuity of business and ability to liquidate current claims. All assets shrink in the process of liquidation, the shrinkage being determined by the degree of organization as well as the breadth of the market. Certain assets are self-liquidating, that is, they provide the debtor with funds within the period of the credit, and these shrink but little in the process of collection. But other assets, such as accounts receivable, are subject to great shrinkage. By reason of the shrinkage of assets credit men have determined upon a more or less fixed proportion that should obtain between current assets and current liabilities in each trade. This ratio is a matter of opinion, varying with the trade and the borrower and the credit man between 1½:1 and 3:1, and averaging about 2:1.

Every trade borrower must be considered on his own merits. The margin of safety can be determined only by experience, and generalizations are dangerous. Consideration must be taken of the business, the management, the general business conditions, and the time when the statement was prepared. Only a very low

margin need be required from any business for whose product there is a steady inelastic demand and quick turnover and cash payment. Likewise, any concern which meets its current liabilities without demur and which takes advantage of the cash discounts offered may borrow with a lower margin than a slow-paying concern, for the slow payments are prima facie evidence of poor business conditions—immobile merchandise, poor collections, overstocked shelves, or overextended business. The margin may be lower in the case of those borrowers who handle the product in the later rather than the earlier stages of its progress from raw material to finished product; and the longer the process of production or the more lenient the terms of sale as to period or extensions of time the higher should be the margin.

The comparative rate of turnover is quite as important as the absolute rate. A high absolute rate warrants a low margin of current assets over current liabilities, for the stock on hand, in the ordinary process of business, can be liquidated soon. A high comparative rate of turnover indicates that the dealer who shows this rate, compared with others in his trade, has higher business capacity, buys his stock wisely, is not overstocked, has fresh stock, and that, therefore, the margin may be comparatively lower. The ratio of average monthly collections made by a concern to the average monthly maturities which it must pay is an important factor in determining the margin of safety, for if the ratio of cash receipts, from cash sales and from collections, to liabilities maturing, is high, liquidation is assured. By these and other determinants a proper ratio of current assets to current liabilities is established, and in the hands of careful credit men and bankers it is the most effective curb on loan inflation and is the guardian rule of the bank.

Mr. Alexander Wall, at the request of the Federal Reserve Board, under the general supervision of its Division of Analysis and Research, has made an extensive study of this ratio between current assets and liabilities. His greatest contribution is the

emphasis upon the advisability of analyzing the current assets from a qualitative point of view. He outlines seven ratios in an attempt to analyze the current ratio, the capitalization plans, and the vitality of the subject business. Since merchandise inventories are figured at cost or less and accounts and bills receivable at cost plus profit, the conversion of merchandise into accounts receivable should increase the ratio of current assets to liabilities. The liquidity of the receivables is a most important factor, as the rapidity of their turnover and the ease of their collection vitally affect the import of the ratio. The ratio between sales and merchandise has a similar bearing. An improvement of these ratios in the qualitative sense may offset a decrease in the quantitative sense. The non-current assets should be contributed by the invested funds of the owners of the business; therefore the ratio between invested funds and non-current assets discloses how much the owners have put into the current part of the business. If the ratio of net worth to fixed assets falls it indicates that the plant is absorbing more of the capitalization and the working capital; such a condition is not healthy. The ratio of sales to net worth indicates whether there is undercapitalization and a feverish condition in the business, or the reverse. And the ratio between the total debt and the net worth discloses the proportions of the total capital that are supplied by creditors and by owners of the business.

The Analysis of Current Assets

Cash should be exactly what it implies, that is, currency in the company's safe and its balances with its bankers. All restricted cash items should be listed separately; they include all moneys held for the purpose of meeting specified payments not actually a part of the company's every-day operations. An example would be sinking fund cash. The working balance should be sufficient to assure its ability to meet demands made on it for cash. This amount may be low if the concern is a regular customer of one

bank on which it can depend for accommodation; but if it borrows through the open market and has no assured bank connections a higher cash balance is necessary. Too large a balance indicates idle money and too small a balance is inconvenient or dangerous; the adjustment between these limits depends upon the business and conditions. In reporting its indebtedness a concern should not deduct its cash on hand from its net indebtedness, since it creates the wrong impression of the concern's condition.

Accounts Receivable represents amounts due for goods sold on open account and should comprise only accounts which are good, undisputed, collectible, of recent date, and free from pledge. Old accounts should be charged off, and a reserve carried for all doubtful accounts. If the terms of sale are, say, 60 days the sum of Accounts Receivable and Bills Receivable should not be in excess of 90 days' sales; this ratio acts as a guide to determine whether credits are too freely extended and collections too slow.

In a merchandising business the item of Bills Receivable as a rule is not large, inasmuch as the custom of transacting business upon open account has become so general. There are exceptions to this where the custom of giving notes is the regular method of settlement, as in the agricultural implement, jewelry, piano, tobacco, and lumber trades. With the development of the trade and bank acceptance, this form of asset is becoming more important. In those trades where notes are used in settlement it is important to determine the proportion of the assets that is composed of notes. The proper normal proportion varies with the trade; any trade which used long-term notes might be expected to have a higher proportion than one with shorter term notes, and a higher proportion than the normal would suggest that the firm's collections were slow and would be a warning to the credit man. It is also important that a firm which sells on open account should have relatively few bills receivable, as their presence would indicate extensions of credit beyond the custom of the trade.

In some cases there are found in Bills Receivable amounts due

from stockholders, representing money lent by the corporation on notes given for the purchase of stock; such receivables should be carried in the statement under separate headings. Special notice should be taken of the notes of the officers, employees, or other interested parties, which could be collected only with difficulty. The items should be analyzed to find which of them are renewals, which are pledged, which rediscounted, and which received from subsidiary concerns, and the total scaled accordingly. It is important that the notes be based on commercial transactions, for goods sold and delivered, and, therefore, self-liquidating. It is quite necessary to have some knowledge of the ability of the concern's managers in order to determine whether they are careful in selecting their credit risks and in being properly secured in cases where collateral is obtained or a lien held against the goods for which the notes are taken.

Merchandise should include only the goods on the shelves or in the storehouses, and, in case of manufacturing concerns, goods which are ready for market. Goods in transit usually are included in the Merchandise item, but it is an advantage to have them listed separately. The appraisal of the Merchandise item requires especial attention, as it is an avenue for the gross overvaluation of assets and for the exercise of fraud. To appraise goods at their cost results in overvaluation, particularly in the case of old and seasonal and fashionable goods, since goods are only worth what they will sell for. To estimate the selling price, however, is still more difficult. The best method is to carry goods at cost unless the market price is lower, in which case the market price should be used. All old and unmarketable goods should be charged off, and a reserve established to cover depreciation. In manufacturing concerns, goods in process of manufacture should be carried at the amount which, according to the cost sheets, has been expended upon them up to the date of the inventory. Raw material and supplies, such as coal, oil, etc., which are in the nature of working assets and are readily salable, are carried at

cost price; but raw materials for specially made wheels for certain kinds of machinery, special devices for particular kinds of plants, or specialized materials should be carried at nominal or liquidation value.

The Analysis of Current Liabilities

Accounts Payable represent money owed for goods purchased on open account. If the volume of accounts payable is large the volume of bills payable should be small, and vice versa. A firm which borrows but little from its banking connections or on the open market is probably letting its bills of sale run to maturity and the item of Accounts Payable would be large. On the contrary, if its bills payable, both those discounted at its bank and those sold through note-brokers, are of large volume, the concern should be in a position to pay its trade obligations within the discount period and its volume of accounts payable should be small. In order to keep their accounts payable at the very minimum and to maintain the highest standing possible with those from whom they purchase, some companies make a practice of anticipating their bills, that is, paying them even before the discount date, in which case they usually get an extra discount at, say, 6 per cent per annum for the unexpired time. An investigation as to how the concern is caring for its purchases in the trade will determine the proper relation of the items, Accounts Payable and Bills Payable, to each other and to the other items of the statement. Note should be taken whether any of the accounts payable are overdue, whether they all represent merchandise bought, and whether there is any merchandise in stock which is not accounted for by bills or accounts payable.

Bills Payable represents either money owed for goods bought or money borrowed. Purchases of goods not bought on account may be settled by notes; money may be borrowed on note by the buyer from his bank or through note-brokers on the open market; notes may also be issued for the purchase of equipment, fixtures,

etc., and for capital advances. Notes floated through brokers and those payable to local banks should bear an inverse relation to each other. If a dealer borrows from his bank to his limit and also on the open market to his limit, he has no reserve borrowing power. If he floats much paper on the market he should reserve his credit with his bank as a defense against emergency. As most businesses are seasonal, the item of Bills Payable will be large when a company is buying heavily, but when its receipts come in from the sale of goods the item should be automatically reduced. This can be checked up from time to time without calling upon the company for a statement, simply by ascertaining its indebtedness to the different banks with which it has relations and the amount of its paper outstanding through its brokers. Information on both these matters may be acquired by direct application to the banks and brokers dealt with.

Wages, Insurance, and Taxes explain themselves.

The Analysis of Fixed Assets

While quick assets and current liabilities are given first consideration and are the parts of the statement to which most importance is attached in considering the advisability of granting unsecured credit, the other items should be carefully investigated and closely watched. These other items are often ignored, for it is "assumed that in the brief period that commercial paper has to run there will be no material change in such fixed assets or slow liabilities." They are a valuable consideration only with a view to ultimate liquidation or to probable continuity of business. The degree of liquidity varies widely and the banker wishes to liquidate his paper with as much ease as possible; if the paper rests upon a commercial transaction which will liquidate it, or if there are sufficient current assets to cover all current liabilities, the paper can be liquidated and the concern kept going. It is only in default of these conditions that foreclosure of fixed assets is resorted to. In the case of those manufacturing an article in the

making of which not many others are engaged, and in the case of those whose property is not centrally located, the items of Real Estate, Plant, Machinery, Fixtures, etc., would not yield much to the general creditor in the event of liquidation; for in such cases the plant is either equipped for the manufacture of a particular line and could not be used for any other line without being entirely remodeled, or it is so located that a different manufacturing enterprise could not be economically located there.

With manufacturing companies it should be known whether the real estate, plant, etc., are entered at a fair valuation, whether they are being kept at a high standard of operating efficiency, and whether proper reserves are being set aside for depreciation, renewals, replacements, etc. In the case of cotton manufacturing concerns the plant is the principal item in the statement, and the current liabilities may fall below the usual 1 : 2 ratio to quick assets and be nearly as large as the latter and the company still be in sound condition, provided its plant is maintained in good condition, is not overcapitalized per spindle, and carries no encumbrance.

Investments in other corporations may constitute very good assets, but in order to determine what proportion of them is quick and what slow, the statement of the company or companies whose stock is owned should be considered in connection with that of the subject concerned. In the case of investments in subsidiary concerns, the statements of the subsidiaries should also accompany that of the parent concern, and where there are several subsidiaries, it is desirable to have a statement which combines those of parent and subsidiaries.

Patterns, drawings, dies, etc., may properly be included in the assets, as well as patents, trade-marks, and good-will. In a going concern these may be very valuable. Some treat these items on a liquidation basis and carry them at a nominal sum. Treasury stock is sometimes carried as an asset; it represents stock of the concern which has been issued and repurchased and held in the

treasury. In analyzing a statement, treasury stock and unissued stock should be deducted from the assets and from the capital.

The Analysis of Fixed Liabilities

The fixed liabilities include the bonded debt and mortgages on real estate. If there is bonded indebtedness the property account should be investigated very closely in order to make it reasonably sure that the bonds are amply protected, for if, in the event of liquidation, the sale of the property should not realize enough to pay off that indebtedness the bondholder would come in for the remainder on an equal footing with the general creditors and weaken the position of the general creditors to just the extent of those claims. Few general merchandising concerns which are floating their paper in the open market have mortgage indebtedness, as it is quite generally held that this interferes to some extent with the sale of their notes or even impairs their credit standing. The bonded indebtedness is just a step farther, the bonds being the evidence of indebtedness supported by mortgage, in order to broaden their market. This does not apply to debenture bonds, which are an unsecured obligation of the company.

The ratio of the capitalization to the value of the plant varies with the line of business, the fixed plant and equipment of a manufacturer usually being very large compared with those of a jobber. Assuming that the whole industry is not overcapitalized, the ratio of capital to plant becomes useful in determining the proper capitalization of any concern in that industry.

Ancillary Items

The statistical items outside of the regular balance sheet which the credit man must have before him are its total annual sales, turnover, net profits, dividends paid, and the amount of insurance carried on its plant and merchandise. The annual sales and terms of sale will indicate whether the concern's capital is being properly employed.

A company's net profits, if conditions of business in its line are not poor, should be sufficient to render a reasonable return to its stockholders, provide for depreciation, etc., and add something to its surplus each year. Dividends should be paid out of net profits alone, and payment of dividends not earned should be investigated. Dividends paid out of a large accumulated surplus are warrantable, the purpose of the accumulations being to render dividends regular, but if repeated for some consecutive years or if paid out of surplus when the amount of surplus does not warrant it, such practice arouses suspicion of the manner in which the company is managed.

Insurance is frequently taken out under a blanket policy. This is done in cases where a company occupies a number of buildings, and under such a policy the buildings would be covered on the loss payable on any one of them. The policy stipulates, however, that the loss payable on any one building and its contents shall be limited to a certain amount. Some large wholesale and retail houses insure their building and merchandise separately, due to a difference in rates. A concern should be watched very carefully to see that it exercises proper care in securing itself against loss.

Anyone desiring to do business with a bank must expect to have an investigation made relative to his standing in the community, his integrity, ability, debt-paying record, etc. If the applicant is to be a borrower he must understand that this investigation will be far reaching; he may reasonably be asked for full lists of his trade references, a statement of the terms of relation to those with whom he has banking connections, and also any questions which the bank desires answered regarding the figures contained in his statement.

CHAPTER XLIX

COMMERCIAL PAPER AND THE DISCOUNT MARKET

The Cash Discount System and Single-Name Paper

The terms upon which American manufacturers, distributers, jobbers, and retailers sell their goods vary somewhat with the different lines of business. These variations rest upon custom, local conditions, or the peculiar necessities of the trade, such as seasonality or perishability of the product, the character of the market, distance between producer and market, etc. The terms granted differ also as among the different houses selling and as among customers buying; the tendency is, however, for the associated members of a trade to charge the same prices and allow the same terms to all. In general, the American system for the last fifty years has been characterized by the open account and cash discount; in some lines, however, the note receivable and the trade acceptance are prominent. The tendency is to extend credit for such period only as will permit the buyer to realize on the goods bought; the more regular the sales throughout the year and the higher the turnover, the shorter is the term of credit allowed.

The cash discount system is as follows: The jobber (or other seller) sells to the retailer (or other buyer) "on terms," such as "2 per cent 10 days, net 30 days," which means that the net invoice price is due in 30 days but that by paying within 10 days, the substantial discount of 2 per cent from the price will be allowed. Payment within 10 days is called "cash" payment, and the 2 per cent deduction "cash discount." The shipments of goods are recorded by the jobber as accounts receivable; they are open book accounts, as the sale is not closed by a signed note or draft, and succeeding sales are added to the account. The goods are sent

under implied warranties, and the accounts are thus subject to dispute at time of settlement. To induce the retailer to pay cash, the discount is made considerably in excess of the interest for the remaining time. For instance, in the above quotation of "2 per cent 10 days, net 30 days," the 2 per cent discount allowed for payment 20 days earlier is equivalent to 37.2 per cent interest per annum.

$$\frac{2 \times 365 \times 100}{(100 - 2) \times 20} = 37.2\%$$

Obviously if the discount allowed were 3, 5, 7, or 10 per cent, as it sometimes is, the advantage of taking the discount and paying cash would be still greater. But if the quotation were "2 per cent 10 days, net 90 days" the advantage would be less, for it would necessitate the retailer using his own funds or borrowing for a longer period to gain the discount, that is, for at least 80 days.

If the retailer can get accommodation at his bank at ordinary rates it is highly profitable to him to borrow the funds and pay the jobber cash. If the retailer does not pay cash the jobber must carry him for the 30 days at least, and to do this the jobber must borrow. Whether the loan is obtained by jobber or retailer, the usual method is to borrow from the local bank on a single-name promissory note, the borrower proving his solvency to the bank by a financial statement.

Since in practice the date of settlement is somewhat flexible so as to accommodate retailers, and since the possible accommodation which the jobber's local bank can extend is often quite limited, big jobbers (and some big retailers and manufacturers) obtain further funds through the sale on the open market of their simple promissory notes for a round amount, adjusting their maturities to those of their book accounts receivable. Such notes are marketed through note-brokers.

Another way in which single-name paper comes into use is in the settlement of overdue book accounts receivable or in exten-

sions granted to weak debtors. Since such notes are not readily discountable and are likely, if known, to injure the credit of the jobber, he holds them in his portfolios and issues his own notes instead. The open book account, cash discount, and single-name paper characterize American sales' terms. Among others, two results are evident: (1) the period of credit extended by the seller has been shortened until American business is nearly on a cash (10-day) basis; and (2) single-name paper composes a very large proportion of the commercial paper of the country.

Two-Name Paper

Instead of selling his goods on credit on open account, the merchant or jobber may require his customers to give him their notes payable at, say, 60 or 90 days. He may take these notes to his bank and ask to have them discounted, in which event the bank requires the same information as to the business ability, character, and capital resources of the promissor and of the customer offering the notes for discount as it would in case either of them asked to borrow directly on single-name unsecured notes. The bank may not make as close inquiry into the responsibility of the maker of the notes, assuming that the man who offers the notes for discount has investigated the makers with care, but may base its real security on the fact that it is acquainted with the affairs of the man who presents the notes for discount and require him to indorse them before granting him the accommodation desired. Although payment at maturity will primarily be sought from the persons who made the notes, the bank will, if payment be not made promptly, require that the person who obtained the accommodation pay the amount involved. Like the trade acceptance or accepted draft, such notes are two-name paper and rest upon specific trade transactions.

An acceptance is a bill of exchange, drawn to order, having a definite maturity and payable in dollars in the United States, the obligation to pay which has been accepted by an acknowledgment,

written or stamped, and signed across the face of the instrument by the company, firm, corporation, or person upon whom it is drawn, it being thereby agreed that the acceptor will pay such bill at maturity, according to its tenor, without qualifying conditions. There are two kinds of acceptances: Where the drawee is a bank or banking house regularly accepting bills drawn under extensions of credit to customers, the acceptances are called "bank" or "bankers'" acceptances; where the drawee is not a bank or such acceptance house, the acceptances are called "trade" acceptances.

It is also proper to distinguish between a "trade" bill and a "finance" bill. The trade bill arises when a seller of goods draws on the buyer; the buyer accepts the bill and returns it to the seller. But the finance bill may represent exchange transactions; it may be for the purpose of carrying stocks of goods or securities, or in anticipation of public loans; or it may be merely for accommodation. The trade bill liquidates a commercial transaction; it may be drawn against a bank or against a buyer of goods, and when accepted it becomes either a bank acceptance or trade acceptance, according to which is the acceptor.

The Trade Acceptance—Nature of

Since the prime purpose in the introduction of the acceptance is to provide a first-rate form of commercial paper for the discount market, the regulations of the Federal Reserve Board determining when the acceptance is eligible for rediscount are in practice very important. To be eligible for rediscount, a trade acceptance must:

1. Be indorsed by a member bank, accompanied by waiver of demand, notice, and protest.
2. Have a maturity at the time of discount of not more than 90 days.
3. Be accepted by the purchaser of goods sold to him by the drawer of the bill, and the bill must have been drawn against indebtedness expressly incurred by the acceptor in the purchase of such goods.

The acceptance must bear on its face, or be accompanied by, evidence in form satisfactory to the federal reserve bank that it was drawn by the seller of the goods on the purchaser of such goods. Such evidence may consist of a certificate on or accompanying the acceptance, to the following effect: "The obligation of the acceptor of this bill arises out of the purchase of goods from the drawer." The federal reserve bank may at its discretion inquire further into the exact nature of the transaction underlying the acceptance, or it may accept this certificate as sufficient evidence.

Depending upon the size of the sales, the seller either sends a separate statement with each shipment, or renders a monthly statement covering the shipments of several small amounts made during the month. He accompanies this invoice or monthly statement with a trade acceptance form duly filled out with the amount due. According to terms of sale the buyer may deduct the 2 per cent in 10 days and pay cash, or he may accept the trade acceptance, i.e., write across the face of the instrument the words "accepted........ payable..........(date)........at....... (such and such bank)......(his signature)......"; he returns the acceptance to the seller and the transaction is closed. The seller either holds the acceptance in his portfolio until a few days before maturity, when he sends it for collection to the bank at which it is payable, or, in case he finds he needs funds, he discounts the acceptance along with others at his local bank or through acceptance dealers. The act of acceptance, therefore, consists in writing five things on the face of the bill: viz., "accepted," the date of accepting, the date of payment, the place of payment, and the signature. The instrument is a time bill of exchange and is an order to pay; but its acceptance is equivalent to the unconditional promise to pay that is contained in a promissory note. Its value is enhanced by the credit of the acceptor and by that of every additional indorser as it circulates in the discount market.

The place of payment is usually stamped upon the face of the acceptance. Under the Negotiable Instruments Law, now uniform in all but five states, a trade acceptance payable at a designated bank is paid upon presentment at maturity at the bank, just as checks are, provided there are sufficient funds to the acceptor's account. The paid acceptances are returned to the acceptor as vouchers. Presentment of the items to the drawee for acceptance may be made through the bank or by the seller himself. The same may be done with its collection when due. If done through the bank the seller may either leave the accepted paper with his bank from date of acceptance to maturity, or may keep it himself until maturity or until he discounts it. The seller may discount his acceptances at his bank, at a discount company which specializes in such items, or through note-brokers. Extensions of time are possible with acceptances, but there must be a definite understanding between the seller of the goods and the buyer to that effect at the time of accepting the original; if the buyer's credit is good and nothing has happened meanwhile to blemish his credit title, there is no reason why renewals could not be freely obtained.

The Acceptance Compared with Commercial Draft

"Trade acceptance" is a new name formulated by the Federal Reserve Board in 1915, for the commercial time draft when used in certain ways. Commercial drafts may be drawn at sight or payable a certain time after sight, and the bill of lading may be attached, the title to the goods covered by the bill of lading remaining vested in the seller, the drawer of the draft, or party to whom the bill of lading is indorsed, until the draft is paid. Formerly such commercial drafts, accompanied by bills of lading, had been used for the most part only when the seller of the goods did not trust the buyer; the result was that customers had come to resent the presentation of a draft with bill of lading attached as a reflection on their credit. Such drafts had also been fre-

quently used as a means of collection when collection letters had failed to produce payment, and customers likewise regarded these as reflections on their credit. By giving up the name "draft" and using "trade acceptance" it was hoped that the presentation of a bill drawn by seller on buyer would be rendered less offensive. The term "draft" continues to be used for sight exchange and finance bills, and the term "trade acceptance" is regarded as an acknowledgment of an obligation arising from a trade transaction and as a promise to pay it on a certain date.

Relative Value of Two-Name and Single-Name Paper

The desirability of two-name paper as compared with single-name paper is wholly relative and dependent upon circumstances. If the person who presents the note for discount is financially much stronger than the maker of the note, it is quite likely that the person's own unsecured note would be nearly as desirable as their two-name paper. If the maker and the presenter of the note should both be parties of small means, the combined responsibility represented in this kind of paper would be of little or no value, and therefore would not of itself make the paper satisfactory. The ultimate test of the security of a note invariably lies in the responsibility of those whose names appear on it, and if one of those names represents undoubted financial stability and moral integrity it is far more desirable to a bank than is paper with several names whose credit is limited or whose integrity is questionable.

As a general rule the responsibility upon which a loan is based is that of the maker. While there are instances in which it may be safe to rely to a certain extent upon the strength of the personal indorsement, it is not good banking to make a loan which is largely out of proportion to the responsibility of the maker. Although such a loan may be perfectly safe, as a rule the indorser's means are not of the character of assets which would make a short-time loan promptly realizable. Partial reliance may often properly be placed on the indorser, the maker being a fair risk and

the indorser sufficiently responsible to give added strength to the note. In judging the value of a personal indorsement, the essential point to be considered is the nature of the indorser's assets, whether they comprise slow or quick items, and whether he can be depended upon to pay promptly and without litigation in case the maker defaults at payment.

Two-name paper is regarded with more favor when it grows out of actual commercial transactions. In this respect the trade acceptance probably excels the promissory note with two names and surely the promissory note with one name, for the reason that it is by its very definition and terms based on a commercial transaction. Any paper which is a true commercial instrument springs from a commercial transaction, represents sales of merchandise actually made, payment for which is agreed to be made shortly in the definite future, and is self-liquidating since it represents a transaction which will provide funds within the period named for its liquidation.

Bank loans on single-name paper are presumably made to the signer until he receives cash for goods which he bought and paid for, but each note represents many such transactions. It may be "based on raw materials or merchandise not yet sold, which may be destroyed, affected by age, or never sold." When a banker loans on a single-name paper he is loaning on mixed security—on goods already sold and represented by accounts receivable and bills receivable, on goods in stock not yet sold, and on general assets. There is a mixing of commercial, personal, and investment credit. He does the same when he discounts notes receivable or acceptances for a customer, for he carefully investigates and weighs the credit title of both names; but with this kind of paper he is surer that the paper arose from commercial transactions and is self-liquidating.

Basis of Security of Commercial Paper

Considered in the aggregate, the security which true commercial paper represents is the security furnished by the purchasing

power of the population and the general condition of trade and industry as a whole. It is based upon the capacity of the population to consume and pay for a definite quantity of goods which are the products of past operations. It rests upon consuming power. But loans, the proceeds of which are used to carry on speculative operations, give no assurance that the borrower will be in a better position to liquidate at maturity than he was at the time of negotiation.

So long as bank paper is limited to strictly commercial paper credit inflation is less possible; and the aggregate of commercial paper must be as sound as the business community itself. It is in consideration of this that the Federal Reserve Act restricts rediscounts to paper arising from commercial, industrial, and agricultural transactions. The promissory note does not always show the nature of the transaction by which it is created, and much reliance, therefore, must be placed upon the honesty and character of the borrower. Single-name paper, inasmuch as it does not disclose the exact nature of the use to which the proceeds are put, requires that great care and discrimination be exercised on the part of the bank; and since it is so generally accepted by banks as the basis of loans it is difficult to know what paper is strictly commercial, and bankers vary in their definition.

The Open Account and the Discount Market

Before the Civil War the commercial practice was to close the contract of sale at the time of sale, by the buyer giving his note to the seller, or by the seller drawing on the buyer who accepted and returned the bill. The country merchant visited personally the jobbing market at periodical times and bought heavily, giving his note or acceptance, which he paid at his next visit. Several factors combined during and shortly after the Civil War to substitute the open account, cash discount system. The wide fluctuations in the value of the greenback made long periods of credit

undesirable to the seller, and to induce prompt payment cash discounts were devised and the period of credit shortened.

Transportation and communication facilities also developed, so that it was no longer necessary to buy in large lots and single shipments or make personal visits to the jobbers. The average size of bills declined, and one loan from a bank was procured to cover what would otherwise occasion many acceptances or notes, as the settlement of accounts of such small size with notes or acceptances would be bothersome. The improved means of communication and travel gave rise to the traveling salesman and sale by sample; except in seasonal lines, visits to the jobbing center by the retailer gave place to regular visits to the retailer by salesmen with samples. So long as the buyer bought by personal selection from an accumulated stock he bought by the rule of *caveat emptor;* but when he buys on the basis of samples he does so under implied warranties, that is, that the goods delivered conform to the standard of the sample; and since the buyer hesitates to pay until the goods are received for inspection unless he receives due inducement, there arose the practice of consignment on open account and of allowing discount for cash within 10 days, whether the goods had arrived by that time or not. Local banking facilities also developed by which the local dealer could borrow on his unsecured note to avail himself of cash discounts offered him.

The absence of double-name paper and a discount market and the existence of the single-name, cash discount, open account system in the United States have been characteristic of our banking and mercantile system for the last fifty years and stand in contrast to the European systems which are based upon the acceptance method. To a degree this distinctiveness has been unfortunate, for it isolated us in international finance and also forced our bankers to an undue dependence upon the stock market. One object in the mind of the framers of the federal reserve was to provide facilities for financing foreign business after the manner

of the rest of the world, to divorce the commercial and financial loan markets, and to create strictly commercial forms of paper and a discount market.

Open-Market Borrowing

Wider mercantile operations and national advertising and the development of credit investigation have given certain houses a national reputation and enabled them to borrow widely in the open market. These loans are procured by flotation of paper through note-brokers. Such paper is sometimes distinctively called "commercial" paper. The nomenclature, however, is not apt, since it confuses the fundamental nature of commercial paper—it may or may not be used in whole or part to finance strictly commercial transactions, and it usurps the name of paper that is assuredly so used. If such paper is constantly renewed it means that the borrower is procuring fixed capital by means of short-term obligations instead of bonds.

When a bank has surplus funds which it is unable to lend to its local customers by reason of there being no demand for them, it usually goes into the open market and buys paper which it considers desirable. This is done through note-brokers, who have become important factors in the banking business. These note-brokers call daily at the banks and present their offerings, and in the case of country banks they usually send daily a list of the paper which they have to offer. The paper peddled in this way consists of receivables, single-name paper, and acceptances. Note-brokerage and other houses that specialize in acceptances are sometimes called "acceptance dealers."

The custom of issuing and buying paper through the open market is a recent growth. Until late years conservative financial men criticized concerns for borrowing on the open market and pronounced it a method of kiting credit. Local banks and interests regarded it as unfair to their community to let funds go outside their district for commercial purposes. A decided change

of attitude has occurred and today a large proportion of the strongest and best concerns finance themselves in part through note-brokers and the open market.

Factors of Development of Open-Market Borrowing

The change is due to several facts:

1. The growth of the open market has contributed most to the development of open-market borrowing. Formerly the market was limited to a few big cities of the East, but since the banking resources of the country have developed so generally and faster than local demand could utilize, banks have sought a field for the safe and judicious employment of their extra funds. The banks have slowly come to realize the safety and high liquidity of open-market paper, which, although an earning asset, has been found to be excellent secondary reserve, convertible at will and with ease. Banks and others in every part of the United States have become buyers of open-market paper and the business of note-brokers has grown enormously.

2. Another factor has been the development of credit departments in banks; to be in a position to purchase paper of concerns with which the bank is not personally familiar, a credit department is indispensable. These departments have become common in large banks, and smaller banks have access to the credit service of their central correspondents. The result is that now, through correspondence, it is usually possible to secure trustworthy credit information about concerns, no matter how distant. The development of credit men's associations, mercantile agencies, and interchange bureaus has worked to the same end.

3. A third factor has been the growth of national concerns, those that do a national business and are well known and well reputed from ocean to ocean. This growth rests upon improved means of communication and transportation, national publicity, and increased capacity for business organization and direction.

Kinds of Open-Market Paper

Open-market paper is of three kinds:

1. Receivables or indorsed paper or two-name paper.
2. Single-name paper.
3. Acceptances.

Receivables are notes which have been received by a firm and are indorsed by it and sold in open market through note-brokers. It is presumed they represent actual transactions; they are drawn in odd amounts and may bear evidence of their commercial origin; they bear two names, the indorsement both authenticating and adding strength to the note. Among the best known receivables were those issued by the great Claflin house before its failure in 1914. Sometimes a company has a selling organization which is separately incorporated, and the goods shipped to this subsidiary are represented by accounts receivable or notes receivable. The parent company may not disclose the relationship existing between it and its subsidiary distributing organization, and may indorse these receivables and sell them through note-brokers on the open market. Obviously this class of paper is objectionable, for the merchandise which the subsidiary still carries is in reality as much a part of the merchandise account of the parent company as if it were on its own premises, and is no warrantable basis for a receivable. Only such of the merchandise as is actually sold by the subsidiary warrants a receivable.

> [One form of indorsed receivable] is the note of a New England or southern cotton-mill, with the indorsement of the New York or Boston commission house which sells the mill's output. Commission houses are of various kinds; some make advances to the mills and some do not; some guarantee the accounts to the mills, while others do not; some own their accounts receivable, and in other cases the accounts are owned and collected by the mills; some commission houses own the mills for which they sell and some mills own their own com-

mission houses. As this commission business is handled in these various ways, the strength or value of a commission house indorsement, aside from the wealth of the concern, is dependent largely on these other factors. The commission house indorsement which is of the most value is, ordinarily, that of the one with wealth and responsibility, which does not make advances, neither owns nor guarantees the accounts receivable, but is willing morally and financially to back the mill whose product they are selling. The cotton-mill notes thus indorsed are familiarly known as "mill paper."[1]

The Note-Broker—Commission Rates

The prime function of a broker is to bring buyer and seller together; a note-broker is the intermediary between borrowers desiring accommodation and the banker or others desiring investment. He establishes a clientele of issuers of paper and a clientele desirous of buying paper. To gain the former he must prove able to place paper in desired sums at desired times; to gain the latter he must offer paper which has attained a reputation for safety or for which he is willing to vouch. This necessitates an extensive credit department, financial responsibility, and dependable service. To reach buyers, a selling organization is necessary; the paper is offered through the mails and by means of traveling representatives who go from bank to bank.

The majority of note-brokerage houses are partnerships, most of them being members of stock exchanges which do not allow corporate memberships. Being partnerships, they are free from much of the governmental interference to which corporations are subject.

The brokers were originally strictly brokers and sold the notes of their clients on a commission and paid for the notes when sold. The usual rate of commission for 6 months' paper is 1/4 per cent of the face value, but some brokers charge only 1/8 per cent.

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[1] Acceptance tract.

The rate depends upon conditions; if there is competition between two brokers for the paper of a certain firm the rate usually falls. The note-brokers have grown to such size and financial strength and good name that most of the leading houses pay the borrower upon receipt of the paper, deducting the commission, and take the risk of disposing of it at a profit. If a broker invests his money in a 90-day note at 6 per cent, charges 1/4 per cent commission, and retains the note in his portfolio till maturity, he makes 7 per cent per annum. If the market rate of interest falls his paper will command a higher price and his profits will rise accordingly; if the rate rises he will hold his paper either for a better rate or till maturity.

Purchases Through Brokers—Risks and Guaranties

To buy the paper outright requires large capital and is hazardous because of the high concentration of risk; this is the principal reason why the growth of the business has not brought a large number of concerns into it. Those brokers who can borrow at banks do so either on their single-name unsecured paper or else pledge the paper which they have bought to sell when the market favors. Large capital is very advantageous in times of tight money, when it is difficult either to sell paper without loss or to borrow to carry it.

Banks often buy paper from brokers on option, the period of option being usually a week or 10 days. Option is common in case of paper on which the bank has no late credit information or on which it wishes further information. Paper bought on option is investigated, and if not fully approved is returned. When the broker delivers the paper to the bank he receives payment of the face value discounted to maturity. If after investigation the bank returns the paper, the broker reimburses the bank by paying the discounted value on date of return. Changes in the market rate of interest during the option may also incline the bank to return the paper; but this sort of dealing would amount to a

speculation at the broker's risk and should not and could not be persistently done.

The brokers do not indorse the paper they sell nor guarantee its payment, though most brokers do specifically guarantee that the paper is regular and genuine, as it has become one of the unwritten laws of commercial-paper dealing that the broker who delivers the paper is bound to see that it is genuine and is issued in due form and course, his credit department giving him full facilities for determining this. The fact that the paper is sold by a house of good standing is considered by some less exacting buyers sufficient to warrant its quality. Banks select carefully the brokers from whom they buy; moreover, as soon as they buy they notify the issuing concern that they have bought its paper and ask a confirmation of its regularity.

The note-brokers handle single-name paper, receivables, and acceptances. The market for single-name paper has been largely restricted to firms with large capital and well-known credit. Brokers find it so difficult to sell paper of concerns having resources from $100,000 to $150,000 that they usually refuse to undertake such sales, and some cater only to firms with a half-million or more assets. The market for the paper of small and less known concerns is restricted since banks find it harder to look them up and satisfy themselves as to the quality of the paper, although the small concerns are often quite as good for the amount they borrow as are the larger ones for the proportionately larger amounts they require. This paper is in the form of notes of standard size, as $5,000, $10,000, $25,000, etc., and running 90, 120, or 180 days, with maturities distributed to synchronize with receipts from sales of merchandise.

Advantages of Borrowing Through Note-Brokers

The advantages to the borrower from issuing its paper through note-brokers include the following:

1. A concern may be able to borrow at lower rates than if it

depended upon local funds. The ability to obtain lower discount rates is not the prime consideration, however. While at times brokers' rates are lower than the rates obtained from the local banks, it frequently happens that their rates are above those charged by banks to their customers; in the long run the average rate would probably not differ greatly either way.

2. Its borrowing facilities are, however, widened; the sources from which it can borrow are increased; and it can keep its ability to secure accommodation from its local banks for emergency when open-market borrowing becomes difficult. It enjoys a desirable independence of the local banks.

3. Many large borrowers need more capital than their local banks can loan, and instead of going around to borrow in other places, they employ the broker who is expert in this line of financing. He covers the country and knows the field, the needs, and the preferences of the banks and the other buyers of paper, and has an effective selling organization in operation. The expense of borrowing through brokers is therefore less than if the concern borrowed directly.

4. A certain advantage also attaches to the open-market method from an advertising standpoint; it helps to make the firm's name known throughout the country. Brokers who have attained a good name investigate carefully the paper offered and their offerings are synonymous with quality; to pass this test and have the fact made known generally over the country reacts favorably upon the firm's credit.

5. The total amount of funds carried as balances with banks is reduced, and therefore the total borrowings are less. Such balances need be carried only with local banks; it is probable that those local banks will require larger balances than if the borrower dealt only or more largely through them. If the borrower expects to receive much accommodation in emergencies it is necessary for him to carry fair balances with the local banks, and such balances reduce the economy of borrowing elsewhere.

Effect of Open-Market Borrowing on Banks

The banks are affected in various ways by open-market borrowing through note-brokers. Some banks dislike to have their customers borrow in this way; it destroys their local monopoly on loans. It is contended by them that competition and rate-cutting by brokers make it easy to borrow money and thus promote dangerous expansion; and they also object to having their customers do all their borrowing on the open market when money is easy and borrow from their banks only when money is tight. On the other hand, the banks may take the position that, if its customers can stand the scrutiny of a good note-broker and anywhere from twenty-five to fifty keen credit department men besides its own examination, the risk is much less, and therefore rather favor than oppose such operations. Brokers sell where discount rates are lowest and therefore tend to equalize the discount rates of the country, thereby rendering credit more mobile and effective.

The banks buy open-market paper to put out otherwise idle funds. The local demand for funds is seasonal and the surplus in banks in one section of the country may occur at the time of high demand on another; by buying commercial paper with maturities adjusted to the probable local demands for funds the banks not only have their funds continually employed and in paper which they are under no obligation to renew, but also have good secondary reserves. Their field for lending is widened and loans are made frequently at better rates than local conditions warrant.

The average local banker depends upon his city correspondent to select his paper and he buys on its recommendation; but it is very possible for him to select and familiarize himself with a few well-known commercial paper names; a third but poor alternative is to depend upon the recommendation of reputable note-brokers. The broker has scrutinized the paper that he offers more expertly than the banker can; and the broker furnishes the buyer upon

request, not only a digest of the borrower's statement, but also a list of houses from which trade references may be obtained and banks which have handled the paper before. The result is that open-market purchases have proved safer than loans made direct. When a bank deals with its customers it tends to take greater risks than in open-market purchase; in making direct loans there is usually the inducement of an account and the banker is in a less independent position; the loan will likely be larger, be made to smaller and weaker concerns, and be more bound to renewals.

Objections to Open-Market Borrowing

Borrowing in open-market through note-brokers is not unattended with danger. The borrower who uses brokers in preference to establishing ample relations with banks for the full requirements of his business runs the risk of being caught in a tight money market; the experiences during the panic of 1907 have brought many men to realize the importance of making broader banking connections to provide against emergency and not to rely too exclusively upon note-brokers.

As a rule, banks do not make loans for a longer period than 6 months; but the practice of making longer term loans has developed in some banks by concerns selling their paper through note-brokers, which paper sometimes runs for 8 or 9 months. Some banks regard this as unsound banking. The lengthening of time of such paper is due to the fact that the broker charges a straight commission on the face of the paper, no matter what the period. The longer the note runs, therefore, the less rate of interest per annum the borrower pays to the broker as commission.

The constant renewal of paper is highly objectionable. It usually shows that the funds are being used as permanent capital, which practice good banking principles dictate should be sparingly used and which likely denotes a weak financial condition on the part of the borrower. A common criticism against brokers' single-name paper is that it is to the brokers' interests to keep as

much of this paper out as possible; at maturity of one batch another is offered, and the constant stream of notes represents fixed investments. The broker holds the paper a very short time, is limited by no reserve requirement, and his earnings vary with the volume of paper placed; therefore, he may be a factor in encouraging expansion beyond the rules of prudence. The borrower is prone to think of frequently renewed borrowings as permanent capital and not make provision for meeting them at maturity. The banker cannot test the solvency of the borrower by requiring a yearly "clean up," for the broker will simply shift his borrowings to other areas or banks.

Probably the most serious objection by banks to the note-broker has been the competition to which he has subjected them. He gathers idle funds from all parts of the country where interest rates are low, and gives them to borrowers who would otherwise have to pay high local rates. In times and places of easy money the competition between brokers and banks becomes very keen. The brokers also compete keenly against each other to get and maintain customers. They may offer some paper at very low prices in order to dispose of other less desirable paper along with it. A demoralization of rates follows. Since brokers have bought the paper outright, any fall in discount rates adds to their profits; accordingly their efforts are bent constantly to lower those rates. They probably tend to make the rates more sensitive and fluctuating. In times and places of high money they absent themselves and let the local banks withstand the situation alone. The brokers not only tend to rob the local banks of customers, but those banks are called upon by the brokers to testify as to the credit title of the customers they are seeking to wean away.

Volume of Open-Market Borrowing

According to the Bank Service Department of the National Credit Office, 3,676 concerns, each with a capital in excess of $250,000, sold notes in the open market between January 1,

1920, and July 1, 1921. These concerns are among the most widely known traders and manufacturers in the United States, in every industry. The classification according to trades of these open-market names is as follows: dry goods, 31.5 per cent; foodstuffs, 22.3 per cent; rubber tires and leather shoes, 8.8 per cent; lumber, furniture, and paper, 6.2 per cent; hardware and automobiles, 17 per cent. The total amount of open-market paper sold during this period by note-brokers was approximately $4,000,000,000, and of this, $3,896,000,000 was liquidated at par without effort on the part of the holding banker. The net loss to the banking community on the total purchases is estimated at .0047 per cent.

The Registration of Paper Sold in Open Market

If several brokers are employed by the same concern there can be no effective check on the amount of paper issued, and credit inflation is facilitated. As a safeguard, the registration of all paper sold in open market has been proposed. Registration will certify the authenticity of the paper and the regularity of the issue; this certification is fairly well done now by note-brokers, but registration would make it invariable. Registration will also check and make it possible to know definitely the amount outstanding. The need of such information was demonstrated by the famous Claflin failure and the default of its receivables. Registration in this case would have apprized the banks of the amount issued and the danger incurred.

Borrowers in the open market have opposed the registration of their paper. Only a few have voluntarily made arrangements for registration. Usually they do not care to divulge their trade and financial secrets to the degree required. Those borrowers who now enjoy nearly a monopoly of open-market borrowing feel no reason for registering their paper. The note-brokers are not inclined to give to the public information about their clients. The brokers also avoid the red tape that accompanies registration.

Registration would simply require a resolution from the board of directors of the borrower, declaring that paper bearing its name is not valid unless registered with its registrar and stamped and signed to that effect. The registrar is authorized and instructed to keep a close record of the amounts, maturities, rates, etc., necessary to identify the paper, and to furnish any applicant a statement of the amount and maturities of the paper outstanding at any time.

Although repeatedly urged by prominent bankers and others from time to time for more than a decade, registration has made little progress toward general adoption. In 1908 a committee of the American Bankers' Association made an exhaustive study of the subject and recommended: (1) the supervision of the issuance of paper offered in the open market, (2) an annual audit of firms issuing paper, and (3) the registration of paper under the supervision of the clearing houses in New York, Chicago, St. Louis, Philadelphia, and Boston. The clearing houses opposed the plan, and it failed of adoption. Four years later there was proposed to the association a central bureau of credit information, which was to be capitalized and supported by fees and which had for its object the safeguarding of paper issues by furnishing information relative to credits, but which would have had the registration performed by selected banks and trust companies. This plan was not adopted.

Registration could be provided under one of three institutions: trust companies, clearing houses, and federal reserve banks. Registration with a trust company has been adopted by a few corporations on their own initiative. The registration includes notes issued, notes indorsed, and drafts accepted. Daily reports are made to the corporation and by the corporation, and the amount of paper outstanding at any time is accurately known. Registration under the clearing house or federal reserve bank would provide that concerns in the city or district should register paper with the clearing house or federal reserve bank.

The Assignment, Hypothecation, and Guaranty of Accounts Receivable

Another form of credit operation which has grown out of the open book account system is the assignment, hypothecation, and guaranty of accounts receivable. In lieu of borrowing on his single-name unsecured note to the bank or discounting bills receivable with the bank, the manufacturer or dealer can borrow on his accounts receivable. Few banks undertake such loans, since they are too risky. The business has devolved upon specialized brokerage or discount houses, and the banks, instead of lending directly by discounting accounts receivable, lend to the discount house on the security which it can provide.

The terms upon which a merchant or manufacturer assigns his accounts receivable vary largely with the nature of the accounts and the standing of the assignor. In case such borrower cannot secure accommodation from banks, he goes to the discount company and, upon assuring it that he has bona fide orders from dealers to purchase goods from him, the company agrees to advance him, say, 80 per cent of the face of the order when it is completed and shipped to the buyer; it makes him pay 6 per cent per annum for the money, 3 per cent commission for transacting the business, and anywhere from 1 to 3 per cent for stationery, legal fees, etc. In order to obtain money in this manner the cost therefore ranges from 9 to 12 per cent per annum, and is too expensive and not resorted to when other methods of borrowing are possible.

The discount company provides him with triplicate bills to be made out when shipments are made, one of which he sends to the discount company and another to the buyer. It is stipulated on these bills that the account is assigned to the discount company and that payment for the same should be made to it. The buyer therefore notifies the discount company of the receipt of goods and accounts to it for them. The third copy of the bill is retained by the borrower for his own records.

When this condition is found to exist, the merchant's or manu-

facturer's credit usually is curtailed by banks and by the trade. In fact, many mercantile houses refuse to sell to concerns which conduct their business in this manner. It has been found that, where this practice is followed, in the event of failure the unsecured creditors receive little or nothing from the bankrupt's estate. No guaranty of payment of these accounts is made by the discount house.

Borrowing from Commission House

The case is different where a manufacturer does business through a commission house; he receives advances to the extent of, say, two-thirds of the value of the merchandise pledged with it, and if it sells the goods it guarantees the accounts, charging a commission ranging from 2 to 4 per cent, according to the amount of detail involved in the business. This particular manner of business ordinarily works no hardship upon the manufacturer. While no large difference in the charge may exist between houses working in this way and those which pledge their accounts by assignment, the charge for selling and guaranteeing accounts is, as a rule, less than where the manufacturer maintains an organization and assumes the credit risks himself.

One prominent New York house advertises its business as follows:

> The company buys commercial accounts from manufacturers, wholesalers and jobbers, having their guaranty for 100 per cent of all accounts so purchased. These accounts are payable in 30 or 60 days and average less than 40. If they are not paid promptly at due date the company reimburses itself from a guaranty fund of 20 per cent or more left in its hands by the manufacturer or wholesaler for this purpose. The company usually pays 80 per cent less the discount in cash at the time of shipment and retains a reserve of 20 per cent or more, to be paid only as said accounts are collected. The company thus has a double guaranty in addition to the responsibility of the debtors to whom its customers ship the goods.

This company raises its funds by sale of capital stock and debenture bonds.

Sometimes a manufacturer does not require advances from a commission house but utilizes it only to sell his goods and guarantee his accounts, obtaining from banks or note-brokers in the open market the credit he requires. If his credit is good, it is not often, at least until recently, that he must pay more than 5 per cent for money, and the saving thus obtained, by the difference between the rate charged him by the commission house and the rate at which he can borrow elsewhere, may at times be considerable.

Simultaneous Borrowing from Different Sources

Sometimes houses will borrow simultaneously, through commission houses, from banks, and in the open market. From the banker's standpoint this practice is unsatisfactory, as the commission house is secured to the extent of practically 150 per cent, the amount which the house is advancing to the manufacturer being about two-thirds of the value of the merchandise, while the banker's loans are unsecured.

In some instances it does not become generally known that a manufacturer who is borrowing from banks is at the same time receiving advances on his merchandise, and when such concerns fail, the creditors are usually unable to collect much on their claims. Somewhat after the manner of commission houses, certain international banking houses undertake the financing of importers by advancing money against merchandise, but when this is done it becomes known through the customary channels, the importers, as a rule, having no particular reason to keep the matter secret.

The fact that there is such a large element of secrecy in the selling and pledging of accounts, and that the method lends itself so readily to fraud upon creditors and discount houses and commission houses that finance the assignors, has led to a demand that all sales and pledges of accounts should be made matters of public record.

The Trade Acceptance and the American Acceptance Council

Effort to introduce trade and bank acceptances as the predominant form of credit extension as between buyers and sellers of goods and to supplant the open book account system has taken organized form in the American Acceptance Council. This council acts as propaganda and organization agent and is conducting a campaign of education through the press, circulars, and platform. The Federal Reserve Board and banks have also encouraged the use of acceptances. The trade acceptance in one form or another is now used by upwards of ten thousand firms and business establishments and the number of its users is increasing daily. Its practicability has now been proved beyond doubt. It offers advantages to the buyer and seller of merchandise, to the banker and banking system, and to the general public.

Advantages of Trade Acceptance to Buyer

Among the advantages of trade acceptances to the buyer of merchandise the following may be mentioned:

1. Any buyer who stands willing to accept the bills drawn by the seller tends to become a preferred buyer in the estimation of that seller. To have the sale closed by a negotiable paper is a great convenience to the seller; it also indicates higher business capacity on the part of the buyer. The buyer is therefore in a position to procure preferential treatment in his purchases by way of prices, terms, discounts, etc.

2. Signing an acceptance at time of purchase forces the buyer's attention to the terms of the contract, and he appreciates more consciously the obligation incurred. He will, therefore, be more likely to provide payment against maturity and will be a more careful and conservative buyer and a better merchandiser. In a short while he will find his credit title at banks has improved as a result.

3. Every buyer is also a seller. As a seller he will find the acceptance very beneficial. He cannot expect to enjoy these

benefits and not reciprocate by accepting bills drawn upon him by those who sell to him.

4. The economies of the acceptance enable him to conduct his business on less capital and either to extend his business at lower prices or enjoy larger profits.

Advantages of Acceptance to Seller

Among the advantages of trade acceptances to the seller of merchandise the following are to be noted:

1. Trade acceptances are more liquid than accounts receivable. The latter can be realized upon by hypothecation or assignment, both of which are awkward and expensive and smack of poor business management. The trade acceptance "thaws" this "frozen" credit—gives it liquidity—for it can be converted at any time by the process of discounting to banks.

2. The seller possesses good commercial paper to offer his bank; trade acceptances are regarded by the banks as better than single-name paper; banks are inclined to offer better rates in the discount of trade acceptances; the federal reserve banks allow the member banks preferential rates on them. The cost of capital is therefore lower for the seller than if he financed by open account.

3. The acceptance indicates that a sale of merchandise has been completed; the buyer has acknowledged the correctness of the bill and goods; the onus of proof that the goods or bill were not correct will thereafter be upon the buyer. This presumption is of some advantage in litigation. In practical business the incidence of that onus of proof is not important, for it is the desire of sellers to create and maintain a clientele of satisfied customers, and they are anxious to adjust disputes amicably.

4. The acceptance reduces the cost of collections. The acceptance will be met at maturity with greater precision than the open account. It will likely be in the hands of some third party who does not have the mutual interests of buyer and seller, and who will therefore insist upon payment according to the terms of

the paper and will not feel an obligation to renew. The buyer knowing this will make more adequate preparation to meet the paper when due. The seller's credit department will be relieved of much expense in handling dilatory collections, accounting, and general records.

5. Under the open account system it is necessary for the seller to finance the sales to all such buyers as do not take their discount by paying cash, and also to finance all sales for the 10 days before the discount privilege expires. The carrying of these accounts throws the burden of the financing on the seller's banks, usually in the reserve cities, and this is a serious matter for the seller because the volume of such accounts may be large, the accounts do not afford a liquid asset, and the risks are concentrated in one borrower rather than in many borrowers and acceptors as it would be if the financing was done by the local buyers. Trade acceptances could be discounted at the seller's bank or in the open market, and, except for the contingent liability of the indorsement, the seller would be relieved of financing the buyer.

6. The seller on open account cannot depend upon his customers taking their discounts and paying within 10 days, nor can he depend upon their paying promptly at the end of the 30 days or other sales' term. It is difficult for him to prepare a budget and plan his financing; to be safe he must borrow enough to constitute a margin above his calculated needs. He must also borrow extra funds to carry as balances with his banks in order to be sure of accommodation when needed. The provision of this added capital increases the cost of conducting his business. The use of acceptances gives greater dependability on due payments by buyers, makes possible a budget, and reduces the total amount of capital needed by the seller.

Advantages of Acceptance to Banking System

The discounting bank and the banking system as a whole find the following advantages among others in the use of trade acceptances:

1. Trade acceptances are more liquid and easy to handle than accounts receivable. The paper is eligible for rediscount at the federal reserve banks and at discount houses and in the open market generally. It constitutes an excellent secondary reserve for the member banks. It is strictly commercial and self-liquidating. The federal reserve banks allow preferential rates for it. Discount companies are being organized to specialize in certain kinds of acceptances; they may come to offer still better rates than the federal reserve banks.

2. Banks will be free from the obligation to renew loans; borrowers frequently request their banks to renew or extend the time of their notes, and the banks are not free to refuse lest they lose an account. The trade acceptance is based on a specific commercial transaction that liquidates it. The banker can discount them freely and, when near his limit, can rediscount; the paper is then in the hands of third parties who have not the relations of buyer and seller and are therefore in an independent position as to granting renewal or extension of time.

3. Banks are restrained by statute and by business expediency from loaning to any one person more than a certain per cent of their capital and surplus. They often find therefore that they are not able to handle business offered to them by some of their best customers. These restrictions are not imposed upon banks in the discount of trade acceptances.

4. Trade acceptances facilitate the work of the credit man of the bank. Their collection is almost always made through banks. This puts the banks in a position to know how the acceptors meet their obligations, what sort of customers their depositors have and who they are, etc.

5. Trade acceptances will probably increase the amount of business of banks, for more of the common business transactions will pass through their hands, such as collections, discounts, rediscounts, commercial advice, etc.

6. Any development of the discount market tends to free the

bank from dependence upon the stock exchange and frees the commercial market and capital from the financial market and capital. This is one of the ideals of the federal reserve system.

The introduction of trade acceptances is not free from danger of abuse. It is highly desirable that they should maintain their high quality. They should be limited to actual current commercial transactions. They should not be renewed, except rarely, many of their virtues hanging upon strict observance of maturities. If the present custom of a trade is short-term credits, trade acceptances should not be introduced to extend the terms; nor should they be used only with slow-pay customers, as such practice would quickly lead to discrimination against acceptances in the discount market. The use of acceptances does not mean that the credit departments of banks or sellers can be less careful and vigilant in credit extensions. Nor may the paying teller or other bank officers scrutinize the paper less carefully for forgeries and fictitious issues.

CHAPTER L

COMMERCIAL PAPER AND THE DISCOUNT MARKET
(Continued)

Bank Acceptances

Bank acceptances, or bankers' acceptances, are those the acceptor of which is a bank, trust company, or some firm, person, or company engaged in the business of accepting or discounting. Checks, drafts, and acceptances are orders to pay. Checks are orders on banks to pay stipulated amounts to bearer or order of some real or incorporeal person, and drawn by a depositor on the drawee bank. A bank draft is an order by one bank on another bank; banks ordinarily carry accounts with other banks, against which they draw drafts and sell them to their customers; these constitute a form of payment that is readily acceptable all over the country. Largely as a result of the recent war a new form of bank paper, known as the "bank acceptance," was introduced into our financial system.

Origin of the Bank Acceptance

The bank acceptance was developed by European commercial states, where it is now the pre-eminent commercial and banking paper. The early English merchants, who developed international reputations, did their own banking. Later and smaller merchants found it necessary to borrow the signature of the large older merchants, as it was cheaper to pay for that service than to bear the discrimination against them in money rates, and in order to have these larger houses accept bills drawn by their customers the smaller houses came to pay a commission. Later many of these merchants gave up merchandising and devoted themselves wholly to finance. Bankers in London are often

called "merchants" as a result. These merchants were especially qualified to grant credit, for they had wide facilities, acquaintance, and experience, knew merchandise, markets, and marketing methods, and possessed capital and proven business ability. They developed England's domestic and foreign trade and gave London her predominance in the money market of the world. Germany, France, and the other European states use the bank acceptance as their basic financial instrument.

In each of these countries a considerable discount market has developed, and this has greatly aided banking and commercial enterprise. The acceptance market has been promoted by large exports and imports, a good ocean transportation system with world-wide connections, the development of marine insurance, the accumulation of a large loan fund at home, loans to foreign governments and enterprises, and government aid to trade and foreign promotions.

Development of Use in the United States

Neither the use of the acceptance nor a discount market developed in the United States. Accepting bills drawn upon them was forbidden to national banks; few states allowed their institutions to accept such bills, and few institutions in states that did permit it used the privilege. Our foreign commerce was financed through London, Paris, Hamburg, etc., and our bankers devoted their attention largely to domestic commerce and used the open account instead of the acceptance method.

The Federal Reserve Act authorized national banks to accept certain bills drawn upon them. The World War made it impossible for European houses to continue their acceptance business along normal lines. American foreign trade suddenly expanded to unknown proportions. New markets were opened in all parts of the world. American banks became aggressive in pushing the adoption of the acceptance method. And in the interim of a few years bankers' acceptances have

taken a prominent place in American bank paper and a discount market of no mean proportions has developed. Foreign countries have become buyers of American acceptances; an international recognition of our new methods of finance now exists, and dollar exchange is quoted in foreign markets along with sterling, francs, marks, lire, etc.

Difference Between the Bank Acceptance and Other Commercial Paper

A bank acceptance differs from a trade acceptance in that the trade acceptance is drawn by the seller of goods on the buyer of goods, whereas the bank acceptance is drawn by the buyer or seller of goods on a bank which has been engaged to accept it upon presentment, for which service it is paid a commission. The credit standing of the acceptance depends upon the rating of the accepting house and of the drawer, most attention being paid to the rating of the former. The accepting house is generally better known than the individuals, firms, or corporations who are seeking to make or receive payment; its paper can be handled more readily, with less credit investigation, and at better rates. Instead of the seller of merchandise drawing a bill on the buyer, the seller will get more for his bill if arrangements are made that it be drawn on and accepted by a banking house.

A certified check is in one sense an acceptance, and some banks use the phrase "accepted" instead of the more common "certified." But it is not an acceptance in the true sense of the term, since the certification is against a deposit account, and is merely a formal acknowledgment that the drawer has the amount on deposit and that the bank will hold the same pending receipt of the certified item for payment.

When a bank accepts a draft or bill of exchange drawn on it, it obligates itself under a contract essentially similar to that of the maker of a note. While the legal effect is thus the same, the use of a bank's acceptance differs from the use of its promissory note.

When a bank accepts a draft or bill of exchange for a customer it merely lends its credit responsibility to its customer in order that he may procure the funds elsewhere. With the acceptance the bank pays out nothing, but accumulates funds during the life of the instrument sufficient to pay it at maturity; but in the case of a note the bank at once pays out bank notes or other money or credits the account of the borrower with deposits. Only when the acceptor discounts or otherwise acquires his own acceptance, before he has received the funds which are to retire it, does the acceptance cost the bank money and become equivalent to a loan.

Factors Which Influence Granting of Acceptance Credits

When the acceptance credit is issued the taker of the credit undertakes to put the accepting bank in funds at or before maturity of the acceptance. This debtor's obligation to provide cover is an asset of the accepting bank; whenever such cover has been provided his obligation is retired, but the liability of the accepting bank continues till maturity. If the acceptor purchases his own acceptance before cover has been made, he in fact is lending money against his customer's obligation to repay him, and such purchase ought to be added to the other loans to that customer in reckoning the 10 per cent limit on loans to one borrower.

A bank may have no funds available for loans and yet may extend its credit by acceptances, for the acceptances will be sold by the customer in open market, that is, the funds will flow from other banks, sections, or countries. Money borrowed may be invested in plant or other capital investment, may be tied up in non-liquid assets, or may be employed to replace working capital sunk in poor ventures; but bankers' acceptances are by definition and intention self-liquidating. Those that are unsecured are based upon commercial transactions that provide for their own retirement automatically, and those that are secured have

commercial collateral which may be liquidated in case of default. Hence acceptance credits may be granted more freely and with greater expectation of retirement at maturity than may loans granted in ordinary course. The Federal Reserve Act makes provision for this.

The acceptor must guard well his reputation. Overextension of acceptances by any banker will lead to discrimination against his paper in the market, and is equivalent to financial suicide. The discount market scrutinizes his paper, weighs the kind of transactions which he helps finance, and evaluates his paper accordingly. But in the case of loans the banker is less subject to this scrutiny of the market, until he seeks to rediscount his loan paper. The Federal Reserve Board has taken note of this difference and in stating the definition and regulations of promissory notes eligible for rediscount requires that the proceeds be used for a commercial purpose; the evidence of such use may be, and in practice usually is, the financial statement of the borrower. This evidence is not altogether satisfactory, for the borrowings may later be invested in non-commercial ways. But in the case of bankers' acceptances the shipping documents covering actual goods in transit bought or sold, or the contracts to export or import, or the pledge of warehouse receipts covering staples, are highly satisfactory evidence of the commercial use of the funds.

Limitations to Acceptance Credits

To guard against excessive extensions of acceptances, the amount of accepting done is limited to commercial transactions, to 50 or 100 per cent of the bank's capital and surplus, to banks with a goodly surplus, and to banks which in the discretion of the Federal Reserve Board are deemed worthy and fit for the privilege. It is easier to overissue bank notes than to overissue bank acceptances, even without these legal limitations, as the former can be paid out as money but the latter are generally issued in payment for merchandise and have a definite date of

payment. Moreover, the dealers in acceptances are bankers experienced in their line and quick to detect any signs of irregularity, and all doubts are publicly reflected in the market price of the paper. In London, fear of this adverse market price is sufficient to restrain overextension. The novelty of the privilege is the only reason for fearing its abuse in the United States. In this country the acceptor's liability is not as keenly felt as it should be; no reserve against acceptances is required; the bank's opportunity for making money is only limited by the amount of bills it dares accept; therefore, it is thought well, at least during the early years of their use, to limit the total amount of a bank's acceptances to 50 or 100 per cent of its capital.

Any bank issuing an import acceptance credit should weigh the credit title and good faith of the customer taking the credit, and in issuing an export credit should weigh the credit title and good faith of the buyer or consignee of the goods. Can and will the taker of the credit provide cover before maturity of the acceptances? The answer to this question requires the application of all the principles of credit-granting. The credit-taker's ability to provide cover will depend largely upon the actual completion of the sale of the goods according to contract. If the consignee lives abroad this study is more difficult and slow. Safety would require that a banker refuse to finance exports on a credit where it appears that the seller is not well able to stand the loss if one should occur. Can and will the consignee complete the sale according to terms; and if he does not, what losses will the seller sustain? The losses will depend upon the nature of the goods, their perishability, depreciation in value, readiness of market in consignee's port, facilities for handling the goods there, expenses involved in transportation, fees, storage, insurance, interest, exchange, etc.

In the light of these inquiries the banker will decide what further security, if any, he should ask from the customer applying for the acceptance credit. He may ask the pledge of collateral

or the guaranty of some third party. Satisfactory arrangements having been made, a letter of credit will be issued, and in due course, when bills are presented, they will be accepted if properly drawn and stamped and accompanied by documents according to agreement.

Acceptance Provisions of Federal Reserve Act

The Federal Reserve Act provides that member banks are permitted to accept drafts which have not more than 6 months to run, exclusive of days of grace, and which:

1. Have arisen from a transaction involving the exportation or importation of merchandise.
2. Or have arisen from a transaction involving the domestic shipment of goods and have their shipping documents attached at the time of acceptance securing or conveying title to the goods.
3. Or are secured at the time of acceptance by a warehouse receipt or other such document securing or conveying title to readily marketable staples.

The member banks may accept bills of the above classes up to 50 per cent of their capital and surplus, and, where permission is obtained in advance from the Federal Reserve Board, up to 100 per cent of their capital and surplus. No member may accept for any one person, firm, company, or corporation, drafts aggregating more than 10 per cent of the capital and surplus of that member bank; but where the drafts are accompanied by documents or other security, this 10 per cent limitation does not apply.

Member banks are also authorized to accept bills drawn on them by banks and bankers in foreign countries, for the purpose of furnishing dollar exchange, as required by the usages of trade in the various countries. These may be accepted to an aggregate amount not exceeding 50 per cent of their capital and surplus,

provided they mature in not less than three months, exclusive of days of grace. This 50 per cent limitation is not included in the limits set upon acceptances drawn against the shipment of goods or against warehouse receipts covering readily marketable staples.

When a member bank purchases its own acceptances before maturity these are exempted from the aggregate of acceptances authorized to that bank. It is not desirable that a bank buy its own acceptances, for, as shown above, they then constitute loans. This is done, however, when a bank seeks to protect its acceptances and to broaden the discount market.

Use of Domestic Bank Acceptances Illustrated

The use of acceptances in foreign trade is more fully developed in Volume V. The second and third types of acceptance named above are used in domestic trade. Suppose A in Cleveland arranges a sale of goods to B in Mobile. B gets from his Mobile bank an engagement to the effect that it will accept a draft drawn by A on it, provided the necessary shipping documents conveying and securing title to the goods to the bank are attached. The goods are shipped, and the bill is drawn and, with the documents attached, is sent to the bank for acceptance; after acceptance it is returned to A, who may immediately dispose of it to his bank or in open market. The accepting bank at the time of acceptance detaches and retains the documents; what further disposition is made of the documents depends upon the agreement between the bank and B. Some time before the maturity of the bill B will supply cover to his bank for the bill. For the service of accepting the bill and undertaking the risk the bank charges a commission, varying with the time and risk involved. The customary charges range from 1/4 to 3/8 per cent for 90 days. Some banks charge a rate of commission equivalent to the difference in money rates between single-name paper and bankers' acceptances.

So long as the accepting bank holds the documents detached at the time of acceptance, it is protected to the amount of the

selling value of the goods. Upon the arrival of the goods in Mobile it may have them removed to a warehouse and kept under its control, properly insured, until the customer provides funds to cover their release and pay the acceptance, at maturity or sooner.

The bank may, however, deliver the documents to B at time of acceptance, and still be within the law and within the regulations which define paper eligible for rediscount with the federal reserve banks. This course leaves the bank without security and dependent upon B to remit cover against maturity. The documents should not be released except upon trust receipt or an agreement by B that so much of the proceeds of the sale of the goods as may be necessary to pay the draft will be deposited with the accepting bank when available and will not be used for other purposes. Abuse of the acceptance privilege is possible in this operation, for the same documents may be attached to a series of bills at the time of their acceptance, one after another. In this way under the guise of financing a domestic transportation which will require a week or two, a 90-day acceptance may be drawn and thus serve to carry goods other than readily marketable staples; and unsecured credits amounting to 20 per cent of the bank's capital and surplus may be granted to one party, whereas the banking law intended to set a 10 per cent maximum on loans to one party.

Functions and Purposes of Bank Acceptances

Bankers' acceptances should be used for current commercial transactions only; they should not be used to finance permanent investments, to provide working capital, or to finance speculations. They should be used only to facilitate the movement of goods from producer to consumer. This includes storage in warehouse, provided the goods are awaiting reasonably immediate sale or delivery to consumers and are not carried as a mere speculation. The acceptance should show on its face the nature of the transaction covered, by reference to invoice, bill of lading,

letter of credit, etc. An undue amount of acceptances should not be issued by any one bank upon any single form of commodity or to any one customer, as such a concentration of risks is dangerous. There is often greater economy in having the acceptor market the acceptances than in returning them to the drawer for that purpose. The acceptances may be renewed a reasonable number of times for good and valid reasons, where the disposal of the goods as originally planned cannot be completed in the period of the first acceptance. But the bank should not be bound by agreement in advance to renew acceptances.

Bank acceptances serve very important functions in our banking system. They align us with the foreign systems. They provide a form of prime two-name commercial paper. They tend to equalize discount rates over the country. If local banks are not in a position, for instance, to carry cotton in local warehouses, they can accept bills drawn on them and these may be sold in districts more flush with funds. They promote the marketing of crops and relieve the farmer or dealer from forced sales. They broaden the discount market and tend to stabilize the rates. They make it possible for the bank to hide the name of the customer whom it is financing. The small dealers are especially helped, as the bills drawn against credits issued to them can be sold with nearly as great ease as the larger bills drawn for the larger dealers.

Eligibility of Bank Acceptances for Rediscount

Any federal reserve bank may rediscount, for any of its member banks, bankers' acceptances which have a maturity at the time of discount of not more than 3 months' sight, exclusive of days of grace. Such acceptances must be indorsed by at least one member bank, and (1) must grow out of transactions involving the exportation or importation of goods; or (2) must grow out of transactions involving the domestic shipment of goods, provided documents are attached at the time of acceptance; or (3) must be secured at the time of acceptance by warehouse receipts

or other documents conveying or securing title covering readily marketable staples.

To be eligible for rediscount the bill must have been drawn under a credit opened for the purpose of conducting, or settling accounts resulting from, a transaction or transactions involving: (1) the shipment of goods between the United States and any foreign country, or between the United States and any of its dependencies or insular possessions, or between foreign countries; or (2) the domestic shipment of goods, provided shipping documents are attached at the time of acceptance; or it must be a bill which is secured at the time of acceptance by a warehouse receipt or other such document conveying or securing title covering readily marketable staples.

Any federal reserve bank may also acquire drafts or bills drawn by a bank or banker in a foreign country or dependency or insular possession of the United States for the purpose of furnishing dollar exchange and accepted by a member bank. Such drafts or bills may be acquired prior to acceptance provided they have the indorsement of a member bank.

A federal reserve bank must be satisfied, either by reference to the acceptance itself or otherwise, that it is eligible for rediscount. Satisfactory evidence of eligibility may consist of a stamp or certificate affixed by the acceptor in form satisfactory to the federal reserve bank.

In interpreting the rules of eligibility the Federal Reserve Board has given it a broad construction in order to facilitate the export trade; for instance, it admits, as eligible, acceptances drawn to raise funds to purchase or produce goods intended for ultimate export.

Forward Transactions in Acceptances

In May, 1921, a New York house inaugurated the plan of purchasing bankers' acceptances for future delivery. This was the first attempt to perform "forward transactions," as they are called, on a large scale in the United States, although they have

been very common in London for a generation. Under the plan, an exporter who expects within 30, 60, or 90 days to receive a bank acceptance in payment for a shipment to a customer, may contract with the acceptance house to purchase the acceptance at a stated rate of discount. Similar procedure can be followed by importers who raise funds for foreign payments by discounting bank acceptances.

On such forward contracts the spread between the spot rate and the future rate of discount is determined by the firm's judgment of money market conditions. If it believes the trend of rates is distinctly downward, the rate for forward transactions may be lower than the spot rate. Usually, however, the forward rate will be about 1/8 per cent per month higher than the spot rate; that is, if the spot discount rate is 6 per cent, the rate for 30-day contracts will be 6 1/8 per cent, that for 60 days 6 1/4 per cent, and that for 90 days 6 3/8 per cent.

Factors Requisite for Creation of Discount Market

A discount market is one which affords the opportunity and facilities for the sale or purchase of commercial paper. Such a market may be organized and centralized in an exchange place, where buyers and sellers meet in person or through brokers; or it may be less centralized and localized and comprise the buyers and sellers and intermediary brokers who communicate with both and peddle their discount paper.

Antecedent to a discount market are standardized commercial instruments. The European discount markets are based upon the bank acceptance and trade acceptance, and the rising American discount market is employing acceptances also as its basic paper. The price paid for discount paper depends upon its supply and demand; a dearth of paper leads to cutting of discount rates to 2 or 3 per cent, and an abundance of paper occasions a rise of rates to 6 or 8 per cent. For the absorption of a great deal of paper there must exist a large loan fund; the fund

afloat in the London discount market has been estimated at $6,000,000,000. On the other hand, funds will not drift to the discount market unless there is a large and steady supply of paper there for sale. There are four important groups composing a discount market:

1. The creators of the discount paper. These consist of:
   (a) The banks and acceptance houses which issue letters of credit and accept bills drawn against them, that is, the bank acceptances.
   (b) The importers and exporters or domestic buyers and sellers, who draw and accept trade acceptances.
2. The buyers and sellers of acceptances. These are mostly banks.
3. The central bank of rediscount, which is the ultimate or residual purchaser. In the United States this buying of discount paper is done by the federal reserve banks.
4. The discount companies and note-brokers. These operate as brokers or middlemen and bring buyers and sellers together. They make the discount market effective by searching out buyers for the supply.

There was no discount market in the United States before the recent war, at least none for acceptances. National banks were not authorized to accept bills drawn upon them until the Federal Reserve Act was enacted. Dollar credits were practically unknown. But war conditions made it both possible and advantageous to use dollar credits and acceptances, and American bankers have striven meanwhile to create a broad discount market. At first the accepting banks had to discount their own acceptances to support them, but the market has grown until on May 4, 1920, the total outstanding acceptance liabilities of all accepting member banks were approximately $674,000,000.

The great difficulties confronting the development of a dis-

count market have been the legislative restrictions that have kept banks from accepting and purchasing acceptances, the ignorance and unfamiliarity of the bankers with acceptances and their uses, the inertia of the banking and business public which clung to the open account system, and the governmental financial operations which by their high rates and spasmodic issues, cut off the market for acceptances. The most important steps in the creation of the American discount market have been the founding of the federal reserve system, the organization of the American Acceptance Council, the founding of acceptance corporations and discount companies, and the passage of the Edge Act.

Acceptance Dealers

Houses having the privilege of accepting bills sometimes find it advantageous to buy their own acceptances or to buy and sell the acceptances of others. Other houses engaged principally in the handling of long-term securities utilize their selling organizations more fully by carrying also acceptances. Note-brokers whose business is largely transactions in open-market borrowing by notes receivable may profitably devote part of their efforts to the sale of acceptances. Still other houses are specializing in acceptance dealings, and act as middlemen between the accepting institutions on the one hand and the investing banks and public on the other.

Acceptance dealers relieve the accepting institution from carrying bills which it has accepted, for by buying the acceptance from the acceptor capital for the underlying commercial transaction is advanced and the acceptor is again in a position to accept bills and thus perform its specialized function. In the second place, the acceptance dealers have broader and more specialized selling organizations and therefore are more expert and efficient distributers of acceptances than the accepting bank. They handle a variety of acceptances, have some for sale at all times, and are able to meet the needs of all types of investors.

They provide a continuous market for both the purchase and sale of acceptances. They study the credit quality of the acceptances on the market, make an appraisal of their value, standardize the paper, and promote the assembling of adequate commercial capital for the discount market.

The chief customers of acceptance dealers are the banks, probably two-thirds of their sales being made to commercial banks, 10 or 15 per cent to corporations and individuals, and still less to savings banks. Sales outside the metropolitan area are largely made to banks in the larger cities, but this market has been but little developed as yet. In the large cities salesmen peddle the paper, whereas the out-of-town business is done through branch houses, correspondents, circulars, telephone, telegraph, etc. Daily offering sheets are sent to the principal customers.

A very large proportion of the capital required to purchase and hold acceptances for sale is procured by borrowing from banks with which the dealers establish intimate relationships. This money is borrowed on call, the call rate of interest being generally lower than the time rate, and call money being more adaptable to the varying needs of the dealers than time money, which would have to be utilized continuously. Obviously the more capital the dealer has of his own the greater is his ability to hold acceptances when the market runs against him and not be forced to sacrifice them.

Advantages of Discount Market to Banking System

The advantages of a discount market to the banking system of the United States comprise the following:

1. The loan fund of the discount market tends to comprise the available reserves of the country. The temporarily unemployed funds of commercial, investment, private, and savings banks, trust companies, insurance companies, corporations, trustees, brokerage houses, discount companies, and private

investors of the whole country, and some from abroad, contribute to this fund. The fund becomes so large that its percentage variations are small, although it does vary seasonally. The banker and business man are normally sure of getting accommodation on the discount market.

2. This fund is mobile. It can be shifted from one end of the country to another in a few hours. One federal reserve bank can liquidate large holdings of discount paper to another, and adjust payment through the gold settlement fund. A member bank may liquidate its discounts by rediscounting with its federal reserve bank. This inter-regional shifting of funds is achieved without the transportation of currency.

3. This process of rediscounting as between member and federal reserve banks, and as between federal reserve banks, tends to equalize discount rates. The discounting tends to occur where the discount rates are lowest, and this tends to raise the rates there and to relieve the demand elsewhere. The same sort of equalization takes place among parts of a federal reserve district as among the federal reserve districts. The operations of note-brokers also promote this equalization.

4. The discount market also equalizes discount rates as between foreign countries and the United States. Acceptances become an international investment. If discount rates are low in New York it is a good place to sell paper, but if they are high it is a good place to buy paper. Such selling and buying by foreigners tends to raise and lower the discount rates, respectively, and to bring the rates in the two countries into equilibrium.

5. The discount market tends to control gold shipments, decreasing the amount and frequency of such shipments. If exchange in London on New York goes low, the English take advantage of the low exchange and purchase acceptances in New York, and American banks sell their holdings of foreign bills to take advantage of the high sterling rates. Later when the reverse conditions exist as to exchange rates, the reverse oper-

ations take place. The excess funds in one of the markets are not, therefore, shipped to the other, but find temporary investment in the discount market, and the expensive shipment of gold is unnecessary in the majority of cases.

6. The discount market performs the common function of all markets, that is, it brings buyer and seller together, and diverts the loan fund to the commodity, area, and user that has the greatest need for it.

7. Eventually the discount market will probably supplant the call-loan market for the temporary investment of funds, relieving the commercial banks from their dependence upon the stock market for such investment and tending to separate the commercial and investment markets.

8. The discount market will provide a better buffer against panic than the call-loan system does. The defense of the gold reserves of the banks of the country against the necessity of shipment abroad is very important, since every gold dollar is the basis of a credit structure of many dollars and every dollar exported reduces the potential credit of the bank many fold.

The want of a discount market has deprived us of the buffer of commercial investments which protects bank reserves in Europe. To defend its gold reserve the American bank's usual plan has been to raise its call and other loan rates, causing liquidation and restraining borrowing. The stock- or bond-secured call loan, which in America approximates most nearly the acceptance in the London discount market as regards convertibility, has proved unsatisfactory, because in great emergencies it cannot be converted without precipitating a panic. Although European banks invest freely in call loans based on commercial paper collateral, they loan only to a limited extent at call when stocks and bonds are offered as security. They have been reluctant to invest in call loans unless the disparity of rates was very high. But with a well-developed and broad discount market in New York, based on acceptances, the federal reserve system should be

able, by raising its rate for acceptances above the London rate, to attract European funds to New York, normally and without special arrangement, and relieve any stringency. Formerly a relatively smaller difference of rates between London and Paris than between London and New York caused the shift of a considerable volume of funds to the place of lowest rate. The flux was freer, for Paris investors knew they had an assured market in London, and vice versa; the wider the disparity of rates the more rapidly was the opportunity embraced and the greater the movement of funds.

If a bank invests its surplus funds in readily discountable paper it is in a position to meet its foreign balances by offering claims upon bankers in the foreign countries with which such creditors are trading.

> [In case the discount] rate should not prove effective in attracting funds, relief would come in other ways. The agencies of foreign banks here which had bills in their portfolios would be restrained by the higher rate from offering them for discount. Sellers of goods in distant countries would soon find it cheaper to draw on London than on New York, and within a few months the volume in our discount market would substantially decline and the volume in the London discount market would increase by an equivalent amount, the effect being to throw off upon the London market credits which had hitherto been carried in New York. This would have the same result as though foreign funds were attracted here for investment.

The financial money market would therefore be defended against panic by a world-wide buffer of commercial capital.

Rediscounts with the Federal Reserve Banks

The Federal Reserve Act provides as follows for rediscounts by members with the federal reserve banks:

> Upon the indorsement of any of its member banks, which shall be deemed a waiver of demand, notice and protest by such bank

as to its own indorsement exclusively, any federal reserve bank may discount notes, drafts, and bills of exchange arising out of actual commercial transactions; that is, notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used or are to be used for such purposes, the Federal Reserve Board to have the right to determine or define the character of the paper thus eligible for discount, within the meaning of this Act. Nothing in this Act contained shall be construed to prohibit such notes, drafts, and bills of exchange, secured by staple agricultural products, or other goods, wares, or merchandise from being eligible for such discount; but such definition shall not include notes, drafts, or bills covering merely investments or issued or drawn for the purpose of carrying or trading in stock, bonds, or other investment securities, except bonds and notes of the Government of the United States. Notes, drafts, and bills admitted to discount under the terms of this paragraph must have a maturity at the time of discount of not more than ninety days, exclusive of days of grace: *Provided*, that notes, drafts, and bills drawn or issued for agricultural purposes or based on livestock and having a maturity not exceeding 6 months, exclusive of days of grace, may be discounted in an amount to be limited to a percentage of the assets of the federal reserve bank, to be ascertained and fixed by the Federal Reserve Board.

The aggregate [amount] of such notes, drafts, and bills bearing the signature or indorsement of any one borrower, whether a company, person, firm, or corporation, rediscountable for any one bank, [may not at any time] exceed ten per centum of the unimpaired capital and surplus of said bank; but this restriction shall not apply to the discount of bills of exchange drawn in good faith against actually existing values.

No federal reserve bank is permitted to discount for any member state bank or trust company, notes, drafts, or bills of exchange of any one borrower who is liable for borrowed money to such state bank or trust company in an amount greater than 10 per cent of its capital and surplus, but the discount of commercial or business paper actually owned by the person negotiating it is not to be considered as borrowed money.

The federal reserve banks, as a condition of the discount of notes, drafts, and bills of exchange for such state bank or trust company, must require a certificate or guaranty to the effect that the borrower is not liable to such bank in excess of 10 per cent of its unimpaired capital and surplus, and will not be permitted to become liable in excess of this amount while such notes, drafts, and bills of exchange are under discount with the federal reserve bank.

No member bank is permitted to act as the medium or agent of a non-member bank in applying for or receiving discounts from a federal reserve bank, except by permission of the Federal Reserve Board.

All applications for the rediscount of notes, drafts, or bills of exchange must contain a certificate of the member bank, in form to be prescribed by the federal reserve bank, that, to the best of its knowledge and belief, such notes, drafts, or bills of exchange have been issued for one or more of the purposes governing eligibility as set forth in the regulations of the Federal Reserve Board.

Need for Standardization of Discount Paper

The definition of the paper eligible for rediscount as fixed by the board is very important, since by the terms of the law the paper eligible for rediscount becomes the paper that may be pledged with the federal reserve agent as collateral for the issue of federal reserve notes or pledged with the federal reserve bank as collateral for advances. Strict definition would, therefore, limit both loans and rediscounts as between member bank and federal reserve bank, and indirectly the volume of federal reserve notes. Moreover the definition tends to standardize the types of commercial paper and borrowing practices; it is desirable, if not necessary, to secure a thorough standardization of paper in order that those items which may perhaps be open to technical objections may be plainly and obviously brought within the require-

ments of the law and regulations which render them eligible for rediscount.

The definition of "rediscountable paper" was framed after much deliberation and consultation with business and banking interests, since it had in it the possibility of revolutionizing our business methods; in fact, it did set the standard of strictly commercial paper, based on the exchange of goods, and is tending to substitute the acceptance for the single-name note.

The regulations of the board on the subject of rediscounts are partly given above, in defining the eligibility of commodity paper, trade acceptances, and bank acceptances, respectively. There remain the definitions of notes and 6 months' agricultural paper.

Rediscount of Promissory Notes and Agricultural Paper

A promissory note is defined as an unconditional promise, in writing, signed by the maker, to pay in the United States at a fixed or determinable future time a sum certain in dollars to order or bearer.

The federal reserve bank must be satisfied by reference to the note or otherwise that it is eligible for rediscount. That the proceeds of the note are not to be used for permanent or fixed investments of any kind may be evidenced by a statement of the borrower showing a reasonable excess of quick assets over current liabilities. The member bank must certify in its application whether the note offered for rediscount has been discounted for a depositor or another member bank or whether it has been purchased from a non-depositor. It must also certify whether a financial statement of the borrower is on file.

Such financial statements must be on file with respect to all notes offered for rediscount which have been purchased from sources other than a depositor or a member bank. With respect to any other note offered for rediscount, if no statement is on file a federal reserve bank must use its discretion in taking the steps necessary to satisfy itself as to eligibility. It is authorized to

waive the requirement of a statement with respect to any note discounted by a member bank for a depositor or another member bank: (1) if it is secured by a warehouse, terminal, or other similar receipt covering goods in storage; (2) if the aggregate of the borrower's obligations rediscounted and offered for rediscount at the federal reserve bank is less than a sum equal to 10 per cent of the paid-in capital of the member bank and does not exceed $5,000.

Six months' agricultural paper is defined as a note, draft, bill of exchange, or trade acceptance drawn or issued for agricultural purposes, or based on livestock; that is, one whose proceeds have been used, or are to be used, for agricultural purposes, including the breeding, raising, fattening, or marketing of livestock, and which has a maturity at the time of discount of not more than 6 months, exclusive of days of grace.

To be eligible for rediscount, 6 months' agricultural paper, whether a note, draft, bill of exchange, or trade acceptance, must comply with the respective regulations which would apply to it if its maturity were 90 days or less.

Open-Market Purchases

The federal reserve banks may, under rules and regulations prescribed by the Federal Reserve Board, purchase and sell in the open market, at home or abroad, from or to domestic or foreign banks, firms, corporations, or individuals, bankers' acceptances and bills of exchange of the kinds and maturities eligible for rediscount, with or without the indorsement of a member bank. The board has provided for the purchase of eligible bankers' acceptances—those growing out of transactions involving importation or exportation of goods, if they have maturities not exceeding 6 months, and those growing out of transactions involving the storage within the United States of goods actually under contract for sale and not delivered or paid for, provided that the acceptor is secured by the pledge of the goods.

CHAPTER LI

THE BOND DEPARTMENT

General Functions and Organization of the Bond Department

A single department, or in the case of a large metropolitan bank a group of departments, is responsible for the purchase, sale, and custody of and the accounting for such securities as bonds and short-term notes. The securities may be bought or sold for the bank's own account or for its customers, domestic and foreign. When bought for its own account, the purpose may be to hold the securities till maturity or to resell them as soon as a favorable market can be found. They may be sold on the stock exchange or "over the counter" to customers calling at the window of the bond cage or to customers reached by "street brokers" who peddle the securities from financial house to financial house, or to correspondents or the general public reached by mail or bond salesmen. The securities may be bought on the stock exchange, "over the counter" from customers or street brokers, from correspondents, or directly from the issuer, as when underwriting or participating in the issue of a syndicate.

The above operations naturally divide themselves into three groups: first, the buying and selling of securities on the exchange and over the counter, for the bank and its customers; secondly, the custody of and accounting for securities bought for the bank's account; and thirdly, the underwriting operations and participations, and the retail distribution of original issues by mail and bond salesmen. The trading is done by a section of the department consisting of a manager, traders, who through brokers trade on the exchange or who deal over the counter and by mail, and clerks who prepare the "trading tickets." The custody of and accounting for the securities are in charge of a section composed

of a manager, bookkeepers, who receive and deliver securities and prepare statements, and junior clerks, who prepare tickets for debits and credits, care for the journals, cut coupons, etc. As a rule the syndicate operations and bond distribution are handled by a section consisting of a few responsible men, usually officers, and their assistants, although many of the largest banks conduct this part of the work through an affiliated bond house.

Bank Investments in Securities

Under our banking system bonds have formed no small part of a bank's earning assets. National banks have been and still are owners of large amounts of the United States bonds, which they were formerly required to buy as security for national bank notes. To the issues of the Liberty Loan and of Treasury certificates of indebtedness banks have subscribed freely, and a considerable fraction of their earning assets has consisted of corporate, state, and municipal bonds. In such ways the commercial capital of the country has become intimately interrelated with the financial capital and investment market. In the absence of a discount market, banks have relied for their secondary reserves upon call loans and bond investments, with their continuous market on the stock exchange, whereas in European banking systems acceptances have proved a more elastic, liquid, and safe secondary reserve.

The local banker has become the financial adviser of his customers, and the metropolitan banker the financial adviser of his correspondents. With the passing of the era of construction when financial methods were looser than they are today and when bond sales were often facilitated by bonuses of common stock, the investor came to realize that the issue of securities needs expert supervision which he personally is incapable of giving to them; he turned accordingly to his local banker for advice, and thus the bank as an institution has gradually entered the security business. A modern bank advises its customers as to the virtues and faults

of the various securities and it may buy and sell them; it also buys and carries securities which it regards as good investments and which it is willing to recommend and sell to its inquiring customers. The commercial banks have thus become important distributers of securities. Their specialized bond departments have been organized to handle the subscriptions, purchases, participations, syndicating, and distributing of securities—activities that resemble those of regular bond houses. This development is a natural outgrowth of the confidence that customers repose in the banker who counsels them about their savings and loans. The banker, accustomed as he is to analyze securities for his own institution, is the natural counsellor and analyzer for his customers; and since banks are under federal or state supervision, the securities they buy must conform to the approved standards of the Comptroller of the Currency or the state banking department.

Banks, therefore, by the purchase of bonds realize several advantages, which may be enumerated as follows:

1. They provide themselves with a secondary reserve, which is also earning interest.

2. They provide themselves with an important means of service to their customers.

3. They have an additional source of earnings in the profits made from the traffic in bonds, profits which may be regarded as the price paid by the customer or correspondent for expert analysis, supervision, and counsel.

4. They realize indirect advantages by pledging bonds as collateral for the security of national bank notes and of government and postal savings deposits.

5. They are enabled to help the government by creating an additional market for its bonds.

The following table gives the amount of the various kinds of investment securities held by national banks on June 30, 1919 and 1920:

	1919 (millions)	1920 (millions)
Domestic securities:		
State, county, or other municipal bonds	$ 323	$ 328
Railroad bonds	412	416
Other public service corporation bonds	276	283
All other domestic bonds	307	310
Claims, warrants, judgments, etc.	52	68
Collateral trust and other corporation notes, one to three years	149	146
Foreign securities:		
Government bonds	194	180
Other foreign bonds and securities	54	61
United States securities:		
United States bonds other than Liberty bonds	1,722	815
Liberty Loan bonds and Victory notes	1,450	1,454
Stocks:		
Federal reserve bank	59	65
All other	50	49
Total	$5,048	$4,186

The savings banks, state banks and trust companies, and private banks on the same dates owned $7,178,000,000 and $7,201,000,000, respectively, of investment securities.

Powers of Commercial Banks with Respect to Securities

The power of commercial banks to buy, sell, and own securities is limited by law as well as business prudence. The national banking laws do not empower a bank to purchase the stock of any corporation other than that of the federal reserve banks and of banks engaged in international or foreign banking, the latter investment requiring the previous approval of the Federal Reserve Board.[1] In one case[2] the Supreme Court has held that,

> The power to purchase or deal in stock of another corporation is not expressly conferred upon national banks, nor is it an act

[1] Section 25, Act approved Dec. 23, 1913, as amended by Act approved Sept. 7, 1916.
[2] The California National Bank v. Kennedy, 167 U. S. 362.

> which may be exercised as incidental to the powers expressly conferred. A dealing in stocks is consequently an *ultra vires* act, and being such it is without efficacy.

It is unlawful for a national bank to acquire and hold the stock of another national bank as an investment or for a speculation. This prohibition has restrained the consolidation of banking by the stock ownership of allied or chain banks. But although national banks are impliedly prohibited from dealing in stocks, they may accept them when transferred to them, bona fide, in satisfaction or payment, or by way of compromise of debts due to or from the bank, or when taken with a view to their subsequent sale or conversion into money to make good or reduce an anticipated loss; this right rests upon the bank's implied power to take reasonable and appropriate measures to secure its own obligations or to collect or secure debts due to it.

On the other hand, the legal inhibition from engaging in or promoting purely speculative business prevents a national bank either buying stock in a corporation organized for such purpose or even taking such stock to protect itself from loss on a pre-existing indebtedness. Stocks legally acquired by a national bank, as above, must be disposed of promptly. The Comptroller requires this action, and the bank can pass good title.

National banks have no power to speculate, traffic, or deal in stocks or bonds, or to buy and sell them for a commission. It has been held not to be incidental to the banking business, nor an implied power pertaining to a bank, to buy or sell stocks or bonds.

Section 5136 U. S. Revised Statutes empowers a national bank to discount and negotiate "promissory notes, drafts, bills of exchange, and other evidences of debt." Bonds are held to come within the classification of "other evidences of debt." It has long been the custom of national banks to deal in government bonds, and the Treasury Department has more or less encouraged the practice. National banks, until the Federal Reserve Act was enacted, were compelled to purchase United States bonds to secure their national

bank notes, and such bonds are still used for that purpose. The Aldrich-Vreeland Act provided for emergency circulation secured by state and municipal bonds; and as financial agents of the government banks have been encouraged to buy and sell and exchange its bonds. It seems likely, therefore, that Congress intended that banks should be permitted to deal in government bonds.

The national banks, also, with the sanction, or at least without the disapproval, of the federal government, have invested freely in municipal bonds; and recently the list of securities which may be deposited by national banks as security for postal savings deposits and United States deposits has been lengthened to include railroad, public utility, municipal, and other approved bonds.

Powers of National Banks with Respect to Securities

The law and court interpretations thereof with respect to dealings and ownership of securities by national banks may, therefore, be roughly summarized as follows:

1. It is illegal to purchase stocks of other corporations, including banks, with certain exceptions noted.

2. It is permissible to accept stocks or bonds from a debtor if this is the only or the most appropriate way to save the amount of the debt; such ownership must be soon terminated; and such transactions must be free from speculation.

3. Bonds may be purchased as "evidences of debt"; the government has directly and indirectly encouraged transactions by national banks in government securities, and, to a less degree, municipal securities.

4. A national bank is not by its charter, or by its statutory or its incidental powers, authorized to act as broker or agent in the purchase of bonds or stocks.

5. While it is lawful to buy bonds in order to secure national bank note circulation, or as an investment for surplus funds, and to sell bonds if need be to save a debt for which they are security,

a national bank has no right to traffic or speculate in them, buying them at a certain time with a view to selling them at an advanced price shortly thereafter.

It is obvious that the intent of the law and courts is to inhibit speculative dealings and at the same time permit the purchase and owning of bonds and their acceptation as collateral for loans. But, as in the case of every attempt by the government to regulate speculation and to distinguish between speculative and non-speculative dealings, no clear-cut definition as to what are and are not speculative transactions has been made. To determine, for example, whether a bank's motive in buying a particular bond is to invest its surplus funds for a long time or to profit from an expected rise in value of the bond within a short time is difficult if not impossible. In most cases the motive is probably a mixture of the two; such bonds are bought as provide a safe investment and are expected to increase in value; and the intention and practice may be to sell the bond if the market turns favorably. It is contrary to the rules of the office of the Comptroller of the Currency to express an opinion as to what are speculative and non-speculative transactions except as they are met with in the supervision of a particular national bank.

Powers of State Banks with Respect to Securities

The powers of state banks to deal in and own stocks and bonds vary in different states. In New York, for example:

> [Such banks are permitted to discount and negotiate] promissory notes, drafts, bills of exchange, and other evidences of debt; . . . to purchase and hold any stocks or bonds or interest-bearing obligations of the United States or of the State of New York or of any city, county, town, or village of this State, the interest of which is not in arrears; . . . to purchase and hold, for the purpose of becoming a member of a Federal reserve bank, so much of the capital stock thereof as will qualify it for membership in such reserve bank; . . . and to purchase and hold the stock of any safe deposit company or organization existing under the

laws of the State of New York and doing business on premises owned or leased by the bank.

The New York courts have held that New York State banks cannot purchase stocks of other corporations for the purpose of selling at a profit. Nor can they purchase state stocks to sell at a profit, except when taken as security for a loan or in payment of a debt. Nor can they become shareholders in railroad corporations.

Transactions in Bonds—Stock Exchange Procedure

Bonds are traded in both on the stock exchange and in what is known as the "over-the-counter" market. Some bonds, for seemingly no particular reason, are traded in almost exclusively on the exchange, whereas others can be more readily bought or sold by canvassing houses which specialize in them, either by telephone or by employing a "street broker," who goes from house to house until he either buys the bonds desired or disposes of them, as the case may be. This last method is, as a rule, the more satisfactory of the two when the transaction covers a large amount.

A stock exchange is primarily a meeting place for buyers and sellers of securities and it is designed to obviate a long and perhaps unsuccessful search for a market. The congregation of prospective purchasers and sellers of securities in one place provides a continuous, quick, competitive, steady, and stable market. The New York Stock Exchange, for illustration, is an unincorporated association of eleven hundred members organized to provide a continuous and regulated market for stocks and bonds; it provides rooms and facilities for the conduct of business, and it seeks to maintain a high standard of commercial honor and integrity among its members. It has elaborate rules as to the listing of stocks and bonds, and for the sale and delivery of these.

The New York Stock Exchange is a national institution in

that many of its members live in other financial centers of the United States or operate branch houses in other cities and in that its influence dominates the financial fabric of the whole country. Although its members are largely brokers, they also include many capitalists who always employ brokers on the floor of the exchange, their membership simply affording them lower commission charges. The exchange maintains a schedule of commission rates from which members are forbidden to depart. Membership in the exchange entitles the member to a "seat" in the board room and the right to trade either for himself or as broker for others. The monopolistic privilege of trading has a capitalized value, varying with the activity of the market; in January, 1920, no less a price than $115,000 was paid for a seat.

There are five hours of trading, between 10 A.M. and 3 P.M., and members are forbidden to make transactions, in securities listed or quoted in the exchange, at any other hours, either in the exchange or publicly outside. All trading is done under strict rules, rigidly enforced. Sales are made under highly competitive conditions; bids are made by eighths of 1 per cent; every active security has its own "post" near which the trading in that security takes place; sales and purchases are made by gesticulations, and the simplest memoranda are kept of the oral contracts to buy or sell a security at a price. There is no exchange of securities at the time of sale in the board room. The constitution of the exchange provides that all offers made and accepted are binding on the contracting parties, and few disputes arise as to the terms of the contract. Orders are conveyed to the exchange floor principally by telephone, the members leasing private wires to their offices.

The stock exchange is the most highly organized and perfect market existing. The number of shares of stock that changed hands on the New York Stock Exchange in 1915 was 172,960,600; in 1916, 235,194,042; in 1917, 184,176,310; in 1918, 144,118,469; and in 1919, 316,787,725. The par value of the bond sales for 1915

was \$956,543,000; for 1916, \$1,152,289,000; for 1917, \$1,062,737,-000; for 1918, \$2,062,827,000; and for 1919, \$3,809,002,650. Probably not more than one-third of the bond business conducted in New York City is done through the exchange.

The publicity given to transactions on the stock exchange enables an observer to determine the drift of the market. It is more difficult to sense the over-the-counter market. The street brokers come into the bank throughout the day with various orders to buy or sell bonds, usually in fairly large amounts; as a result of the impression gained from his conversation with these brokers, and also from the character of their orders, a dealer may sense a change in the general market atmosphere. To illustrate, a large number of bonds may be offered for sale, but bids may be few and slow. When this situation prevails, the dealer will probably be chary about buying; if he bids at all, it will be likely to be at a price below current quotations. If by chance the bonds are sold to him immediately at his bid, he will tend to become even more cautious, unless, of course, he has some very definite ideas about market conditions. Or, if the conditions are reversed as when a few offerings are eagerly taken from him, he may stop selling for the time being.

Execution of Orders

The bond department executes all orders for the purchase and sale of bonds for the bank's correspondents and customers, both foreign and domestic. No commission for this service is usually charged outside the regular fee the bank may have to pay when a broker is employed. This part of the business, though involving a great deal of work and trouble, is done gratuitously on the theory that if the people acquire the habit of giving their bank all their orders they will very frequently make their selection from the bonds the bank has on hand.

Some orders set a maximum or a minimum price at which they are to be executed; others are to be handled at the best

market price, this method being, with the ordinary active issues, far the more satisfactory of the two.

The procedure in handling market orders varies in accordance with the peculiarities of the particular security covered by the order, such, for instance, as whether the bonds are widely held and have an active market, or are closely held and have an inactive market, whether it is known that a certain house or houses are actively campaigning to sell the issue and are anxious to maintain a satisfactory price for them, etc.

A metropolitan bank observes the rules of the local stock exchange in all its bond dealings, although only bound to observe them when dealing directly with members of the exchange. On the New York Stock Exchange the rules provide for trading in bonds for "cash," "regular delivery," and "buyer's or seller's option." The usual method is regular delivery, which means that bonds purchased or sold on one day are to be delivered on the next day with interest to the date of delivery; if the purchase or sale is made on Friday or Saturday, the regular delivery day is the following Monday, and if made on a day before a holiday, the first business day after the holiday is the regular delivery day.

In cash transactions the bonds must be delivered the day on which the purchase or sale is made. When trades are made at buyer's or seller's option, it is usual to specify the number of days allowed, and also whether or not the delivery is to be made at the option of the buyer or seller. "Seller 20" indicates that the seller has 20 days from the date of sale in which to make delivery; "buyer 20" means that the buyer may demand delivery at any time within 20 days from the date of purchase. In such trades, interest at the rate specified on the bond is computed up to and including the date of sale, after which interest may either cease or be computed upon the contract price plus accrued interest, at a rate mutually agreed upon. In general, bonds on the exchange are dealt in "and interest," which means that to the price of the bond must be added the accrued interest from the last interest

payment to the date of delivery at the rate specified in the bond. Income bonds and those on which the interest is in default must be dealt in "flat" and must carry all unpaid coupons. Interest is computed on the basis of 360 days to the year and 30 days to the month.

In the bond department all purchases and sales are recorded on tickets, numbered consecutively and having spaces for the name of the buyer or seller, the amount, a description of the securities, their price, and instructions regarding payment and delivery. When trades are made, these tickets are filled out and sent to the accounting and recording section of the department.

The Accounting, Recording, and Custody of Bonds Bought

Clerks in the bond cage figure and check the cost of the bonds, and prepare the tickets which go through the bank. These include:

1. The debit and credit tickets, which are entered in the general ledger and are then sent to the bookkeepers of the check desk department.
2. The journal ticket, which is retained in the department.
3. An advice of the debit or credit to the customer concerned.

If an account is charged, the proper authority must be attached to the charge ticket and the signature of the official giving such authority must be verified. When an account is charged and the securities forwarded, it is well to send the advice of the amount charged and the securities in the same registered letter.

A set of cards covering all issues of securities owned by the bank is kept for the use of the traders, each issue being listed on a separate card. These cards are ruled with debit and credit columns and show in detail from whom bonds have been purchased and to whom sold, with the date and price. Opposite the notation

of the last sale is an entry of the number of bonds owned by the bank and the price or book value. The bonds may be carried at cost, exclusive of interest, less the price received for any of them when sold. If the market depreciates greatly, conservative banks will straightway write off the value at which the bonds are carried; or the Comptroller of the Currency or the clearing house bank examiners may require the banks to do so.

The price of the latest purchase may be used in determining the proper carrying value of similar securities. When this price is used, the bookkeeper figures the new book value on all the issues in which trades have been made the preceding day. A purchase or sale of one bond, unless made at the exact price at which they stand on the card, changes the book value of all the bonds of that issue owned by the bank. When a purchase is made, the number of bonds bought is added to the number owned, and their cost is added to the cost of those previously owned. The total number of bonds is then divided into the total cost to give the price or book value per bond. When bonds are sold, their number is subtracted from the number owned, the proceeds of the sale are deducted from the cost of the total bonds on hand, and the total number of bonds left is divided into the cost left, to find the book value. When on the same day some bonds are sold and others of the same issue are bought, the net change in price is used in calculating the new book value.

The Bond Ledger

All transactions are entered in the bond ledger. The ruling of the debit and credit side of this ledger is identical and has columns for date, par value, name of purchaser or seller, "flat" price, "and interest" price, amount paid or received on account of the principal of the bond, and the amount of interest paid or received. All issues owned by the bank are indexed, say, in the front of the ledger, but when securities other than these are purchased or sold for a customer, the entries are made in a miscellane-

ous section of the ledger, alphabetically arranged. A full description of the securities is entered in the index and also on the folio where the account is kept. This description includes the name of the issuing corporation, the kind of bond (first mortgage, general mortgage, etc.), the date of issue, date of maturity, interest dates, and whether purchased for the bank's own account, joint account, participation, or syndicate.

A separate ledger is kept for United States bonds, because these securities are used for securing national bank notes and therefore require to be specially reported to the Comptroller of the Currency. This ledger has columns for the price, par value, premium, and interest, and also contains a record of bonds borrowed and loaned and of bonds to secure circulation.

Once a month the bookkeeper strikes a trial balance of the bond ledger, and this balance sheet is sent to the loan and discount departments and the foreign division for checking by them, to guard against a loan exceeding the legal 10 per cent limit of loans to one borrower. The ownership of the securities of a corporation is regarded as a loan to that corporation.

Several other statements are ordinarily prepared in the bond department. For instance, a daily statement of all purchases and sales made for the bank's account and showing the balances of the ledgers is prepared for the cashier; a weekly statement of like contents is sent to the directors' meeting; and a periodical statement is drawn up of the kinds of bonds owned—municipals, governments, tractions, and so on.

The Bond Earnings Book

The bond earnings are kept in detail in an account in the back of the bond ledger or in a separate bond earnings book. The sources of earnings are interest, trading profits, joint-account profits, participation, and syndicate profits. The interest on the United States bonds must be reported to the Comptroller of the Currency and is therefore kept separate from other earnings.

Accrued interest on all securities owned is figured on the last day of each month and credited to bond earnings. A monthly statement is prepared giving these earnings in detail.

Because of the different purposes for which commercial and savings banks buy and hold bonds, methods of calculating the earnings from the bonds owned also differ. In commercial banks the amount of interest due is determined by figuring the accrued interest on the bonds on hand, from the last interest date to the date under consideration; to this is added the amount of interest received on bonds sold, and from this total is deducted the amount of interest paid on bonds bought, the result being the amount of interest actually accrued.

Other profits are entered only when actually received. For instance, if the bank is carrying $100,000 of bonds at a cost which, at market quotations, shows a considerable profit, this profit is not entered in the earnings book until all the bonds are actually sold and delivered, unless, as sometimes happens, bonds are actually sold under such favorable conditions that the bank still has bonds on hand and a credit instead of a debit balance in the account. In this event the bond ledger may be charged and the bond earnings book credited with an amount which makes the bonds stand a few points below the market quotation.

If bonds are bought at a discount, they increase in value as they approach maturity, and savings banks, which buy the bonds with the expectation of holding them until maturity, rightfully add this accumulation to their cost as they are revalued from time to time. Commercial banks, however, buy bonds more as a dealer, who invests his funds in earning assets and not with the expectation of holding them till maturity. Whenever it is possible to sell them to advantage—and customers are sought all the time—they are sold and the proceeds are immediately reinvested in other bonds. The accumulation of discounts is, therefore, a less important source of profits and the increases in value are not entered in the earnings book until the bonds are

sold. The conservative bank, however, amortizes the premium and writes off any great depreciation in the value of any bond held a long time.

For the same reasons commercial banks calculate the yield of bonds differently from savings banks. To a savings bank a 5-year bond yielding 5 per cent payable semiannually, if bought at 95, would yield 6.2 per cent; to a commercial bank, which disregards the time element, such a bond would yield 5.26 per cent and be entered in the $5\frac{1}{4}$ per cent rate, as the rates are usually figured in divisions of $\frac{1}{4}$ per cent. This yield is obtained by dividing the amount invested into the annual income received ($5 \div 95 = 5.26$). A book is kept to show the average daily yield on all securities carried by the bank; at the close of the day's business the average yield is computed and the figures are sent to the general bookkeeper to be used in ascertaining the average daily income from all investments.

Other Books of the Bond Department

Other books commonly kept in the bond department are the number book, the vault book, and a separate journal for each ledger. No description of transactions needs to be given in these journals, since each ticket can be entered under the number assigned to it and the transactions traced in this way. The bond journal would then be ruled with columns for ticket number, par value, principal and interest; and the United States bond journal with columns for ticket number, par value, and premium.

The numbers and denominations of all bonds purchased or sold for the bank's own account are recorded alphabetically in a number book, wherein the number of the purchase or sale ticket also may be the means of identification. When purchases or sales are made for customers through a broker, the numbers of the bonds may be recorded on the back of the sales ticket, instead of in the number book.

As a precaution against wrong action, it is commonly required that two men be present when securities are withdrawn from or placed in the vault. Each morning the securities to be withdrawn are listed in the vault book, and at the close of the business day those received by the department and not delivered are entered in the same book. Every item in this book is checked against the journal tickets. In addition, the disposition of every bond must be accounted for, either by delivery against payment, as in the case of brokers, against a receipt from either the purchaser of the securities or from the customers' securities department, or against the affidavit of the registered mail or express letter.

All bearer securities are shipped by registered mail and insured, unless specific instructions are received to forward them in some other manner.

A careful examination of all bonds received by the department is of the utmost importance, to see that they are properly signed and sealed, and, if registered, that a power of attorney, properly executed and guaranteed, accompanies the bond. If the bonds are in coupon form, it is essential that the next maturing coupon be attached.

Syndicates, Participations, and the Distribution of Original Issues

As explained in Volume I, Chapter XI, in the flotation of large blocks of securities it is customary for a banking house or group of banking houses to contract with the issuing corporation to underwrite the issue. The agreement, of course, varies with conditions. The contract may provide simply that the banking house or group of banking houses guarantee the sale of the whole issue within a given time at a minimum price; or in case the corporation handles the sale and does not succeed in selling the whole issue at the agreed price, the banking house or houses will take over the securities remaining unsold. The agreement may

provide that the sale of the securities be conducted by the bank which took the initiative, the other members agreeing simply to take their proportion of the securities not so sold. The agreement between the syndicate and corporation may be practically a joint purchase of the issue, the securities to be distributed at once among the members; or a single banking house may contract with the corporation to handle the sale of an issue of securities, forming a syndicate and allotting to other houses certain proportions of the risk and profit.

Though syndicate operations are largely conducted by bond and brokerage houses, national banks and state banks and trust companies in the financial centers are often members of syndicates and participate in syndicate allotments. The securities are taken by the banks for their own permanent account or for sale to their customers and correspondents.

Commercial banks are prohibited by law from owning corporate stocks, and there are legal limitations to their dealings in bonds. The Comptroller of the Currency has sought to dissociate such banks from the bond business. For business reasons it is expedient that they carry only readily salable assets. As the syndicate operations of commercial banks are thereby much circumscribed, some of the larger banks have organized affiliated bond houses to take over their bond business, the shares of which are transferable only with shares of the bank. The control and profits of the bond house therefore belong to the bank stockholders, but the risk to the bank is lessened, while the bond house enjoys greater freedom in its operations in securities than does the bond department of a bank. Examples of such bond houses are the National City Company affiliated with the National City Bank of New York, the Chase Securities Corporation affiliated with the Chase National Bank of New York, the Shawmut Corporation with the Shawmut National Bank of Boston, the Guaranty Company with the Guaranty Trust Company of New York, etc.

No commercial banks maintain organizations for selling bonds through the country by personal salesmanship or by mail or other advertising. Most banks carry some bonds which they offer to customers and correspondents on application, and some banks sell small quantities of bonds to applicants over the counter.

CHAPTER LII

OPERATIONS OF THE BANK AS TRANSFER AGENT, REGISTRAR, FISCAL AGENT, TRUSTEE, AND SAVINGS INSTITUTION

Functions of a Transfer Agent and Registrar

Commercial banks in financial centers act as registrars for stocks and bonds and as transfer agents for stocks. Although the two functions can be conveniently performed by the same bank department, and although they are often confused in the popular mind, they are distinctive. The duties of transfer agent and of registrar for any corporation cannot be performed by the same individual, firm, or corporation. The stock exchanges in their constitutions or by-laws require that all active securities listed with them be registered with some duly appointed registrar who assumes the duty of preventing the overissue of the stocks or bonds and of keeping a record of the legal holders of those securities.

The stock exchanges also require that any corporation whose securities are listed with them maintain for the convenience of the traders a transfer agent in the cities where they are listed; and such agent assumes the duty of transferring the stocks of the corporation and giving clear titles to new certificates of stock issued in lieu of the old. It is obviously illogical for the same agent to act both as registrar and as transfer agent for any issue of securities, because the registrar's function is to act as a check upon the transfer agent against errors or irregularities. A corporation may act as its own transfer agent, but it cannot act as its own registrar.

Incidental to these major duties are certain minor duties, such as handling subscriptions, issuing stock for new companies

and increases of capital stock or bonds of corporations, exchanging stocks for bonds or vice versa, preparing dividend and interest lists and sometimes paying dividends and interest, keeping the seal of the corporation, etc. The transfer department acts also as transfer agent for the stocks of the bank itself.

A bank may act as transfer agent for certain corporations and as registrar for others; but ordinarily the work required in the two capacities is performed by one department, sometimes called the "transfer" department. The internal organization of such a department varies, of course, with the bank and the volume of this kind of business, but the essential clerical duties are handled as follows: The department is administered by a transfer clerk, who is assisted by an assistant transfer clerk, who may also act as windowman. The windowman receives the securities over the counter, by registered mail, and from other departments of the bank, passes upon the certificates, watches the stop-transfer sheets, etc. Immediately under him is a clerk who prepares the transfer sheet of incoming and outgoing certificates, and a proof clerk who handles the proof book with entries taken from the stock ledgers. The register is handled by the register clerk; the stock ledgers and postings are cared for by the bookkeeper. In a large department are also several general utility clerks who are shifted about as necessity may require.

The Registration of Corporate Stocks

The purpose of the registration of corporate stocks and bonds with an independent registrar is to see that no more than the authorized amount of these securities is issued, and in the contract by which a corporation appoints its registrar it is specifically stated that the bank or other party is appointed to register the corporation's capital stock or bonds consisting of a specified number of shares with par value of such and such amount. The stock exchange then notifies the registrar-elect that it is authorized to register a certain number of shares of the subject corporation.

The use of registrars dates from the '60's, when a certain railroad official manipulated the market, causing panic and ruin, by over-issuing shares above the authorized capital stock. The practice is now so generally recognized by the exchanges, corporations, and purchasers that any securities not registered with a responsible registrar may well be regarded with suspicion.

The registrar keeps the registry list, and after the stocks have been transferred either by the company itself or by its duly appointed transfer agent, the registrar receives in each case the old canceled certificate and the newly issued certificate, proves them, takes a record of the surrender and cancellation of the old and of the issue of the new in substitution, and by his signature identifies the new as legitimate. The registration implies that the registrar guarantees that the new certificate has been issued in regular form by the transfer agent and that the outstanding registered stock does not exceed the authorized amount.

The courts sometimes hold the registrar liable for certain other implied and incidental responsibilities, but there is no law specially fixing the liabilities of registrars and few decisions of courts throw light on the matter. To make sure of the obligations involved, a bank or trust company on becoming registrar for a corporation may enter into a contract specifying them in detail. It is a much disputed point whether the registrar acts only in the capacity of agent for the corporation when registering, from time to time, the respective certificates, or whether the registrar is under financial responsibility either for the stock issued illegitimately by him or for any uncanceled certificates in lieu of which he has issued new ones. Since the purpose of registration is to protect third parties, the registrar should apparently be held financially responsible; but he does not have the facilities for determining the propriety of transfers as made by the transfer agent, because signatures, powers of attorney, probate certificates, and other necessary papers are filed with the transfer agent and not with him.

Procedure and Functions of Registrar

When a bank or trust company becomes registrar for a corporation, certain information is required relative to the total amount of stock authorized to be issued, if none has been issued as yet, and the authorized amounts issued and outstanding, if any issue has been made. After the total authorized stock has been registered, new certificates are not issued except on surrender and cancellation of an equal amount of the old outstanding certificates. Registrations are usually presented before 11 A.M., so that they may be entered in the register, signed, and returned to the transfer agent in time for delivery by 1:30 P.M. The new certificates are entered on the credit side of the register, and the canceled certificates on the debit side, the date of cancellation being stamped in the column provided for that purpose. Monthly or quarterly the registers are proved by totaling all the outstanding certificates on the registers and checking the total with the amount of outstanding stock.

Each certificate received by the registrar must be examined for the authenticity of the signatures of the duly authorized officers of the corporation and that of the transfer agent, for the filling, and to see that the certificate is cut for the correct number of shares. A separate stock register is kept for each stock registered, and if the company has two or more kinds of stocks, such as common and preferred, a separate register is kept for each kind. The register contains columns for the certificate numbers and the amount of the shares of stock of which the certificates have been canceled, for the new certificates registered, the date of registry, the name in which the new stock is issued, and the date of cancellation of the old certificate.

The Transfer and Registration of Bonds

Coupon bonds are usually made payable to bearer and ownership passes by delivery. When it is desired that bonds shall not pass by mere delivery, they are registered, that is, issued in some

particular name and thereafter are transferable only on the books of the company. Most coupon bonds may be registered as to principal, but the coupons still remain payable to bearer; the principal then is payable only to the registered holder whose name appears on the books of the company. On all bonds that can be registered as to principal, space is provided for the name of the registered holder, the date of registration, and the signature of the registrar.

Bonds without coupons attached are always fully registered and are transferable only by assignment. Interest thereon is payable to the registered holder. Coupon bonds and registered bonds are in most cases interchangeable, and the holder of a coupon bond may exchange it at any time for a fully registered bond, or vice versa, on payment of a small charge—perhaps $1 for each new bond issued—to cover the cost of engraving. The advantage of owning the unregistered bond is in the readiness with which it may be sold or transferred, whereas the advantage of the registered bond lies in the difficulty of its negotiation should it be lost or stolen.

When bearer coupon bonds are presented for registration they should be accompanied by a written memorandum giving the following information: amount, date, title, and particular issue of bonds, whether to be registered fully or as to principal only, in whose name to be registered, address, bond numbers, number of next due coupon, and name of the firm or individual presenting the bonds. If the bonds are presented for transfer over the window, a ticket is given to the person presenting them, and they are delivered only upon the return of the ticket properly filled in and signed. Should bonds be received by registered mail or express, they are returned after registration in the same way as received.

When bonds registered either fully or as to principal only are presented for transfer and registration, the bank may require an irrevocable bond power to be executed by the registered holder,

and if the signature is unfamiliar, the bank may require it either to be guaranteed by another bank or by a member of the local stock exchange or to be acknowledged before a notary public. In the case of such an acknowledgment, the bank may require the county clerk's certificate as to the authority of the notary to be attached to the acknowledgment.

When bonds are fully registered, an interest order must be executed by the registered holder, stating to whom interest is to be paid and the address of the payee.

The following books are used in transferring and registering bonds:

1. The Transfer Book. This contains the names of the persons from whom and to whom the bonds were transferred, the bond numbers, and, in the case of coupon bonds, the number of the coupon next due, the ledger folio number of the account, and a record of whether the bonds were received by registered mail, express, or over the window.

2. The Index. This contains the names and addresses of all registered bondholders, the total amount of bonds held by each, and, in the case of fully registered bonds, the name of the person to whom the registered interest is to be paid.

3. The Ledger. In this are recorded the names of the registered bondholders, the bond numbers, the dates on which the bonds were registered, the dates on which they were transferred from one name to another, and the total amount of bonds registered in each name.

4. The Recapitulation Book. This gives the total amount of registered coupon bonds and the total amount of fully registered bonds.

No record is kept of bearer bonds.

The Payment of Registered Interest

The bank may or may not handle the payment of the registered interest on the issues of bonds for which it acts as registrar.

At the request of the corporation, the bank may furnish it with a list of the fully registered bondholders, and the checks for the registered interest may be mailed direct from the corporation's office. On the other hand, the corporation may send the bank a check for the total amount of the registered interest and have the bank mail checks to the registered bondholders, in accordance with the mailing orders on file with the department. Such a check is credited to a special account and the checks which the bank sends are charged to this account as they are returned and paid. After the checks have been mailed a list is sent to the company giving the names of the registered bondholders, the total of the bonds held by each of them, and the amount of the check mailed to each one.

Transfer Agent for Corporate Stocks

A certificate of stock is usually an engraved piece of paper bearing the signatures of the president and treasurer of the issuing company and specifying that the holder whose name is written on the certificate is the owner of a certain number of shares and that the shares are transferable only on the books of the company in person or by attorney upon surrender of the certificate. The certificates are usually made out for 100 shares or some other round lot, depending upon the trading unit of the stock exchange. Although some exchanges provide for "odd lot" sales, say, for example, 47 shares, generally the holder of such lots is at a disadvantage when he wishes to sell; and the necessity for a separate certificate for each share of stock is a cumbersome method of handling and transfer. If a stock exchange adopts, say, a 100-share trading unit, it may require that certificates for 100-share lots be printed from a distinctive plate and by a concern approved by the governing board. These and other precautions are taken against counterfeiting.

A corporation may have its certificates transferred by a transfer clerk in its own offices. If, however, its stocks are very active

in the market and if it has large issues outstanding, the work of transferring the certificates of ownership on the books of the company may become a large task, and to facilitate transfers, the listing committee of the stock exchange may require the company to provide a transfer agent in the financial district of the exchange. In fact, it is now customary for corporations to appoint another responsible company, usually a bank or trust company, to perform this function of transfer agent. Such bank or trust company may act in this capacity for many corporations—up to a hundred, or even more—delegating this work to its transfer department.

When a bank or trust company accepts an appointment as transfer agent, it requires certain information regarding the corporation's organization and issues of stock. No bank can afford to undertake work of this character which might reflect unfavorably upon its own good name. The information commonly required is: a certified copy of the charter, certified minutes of the organization, meetings of the incorporators, a certified copy of the by-laws, certified copies of all votes of stockholders and directors authorizing stock issues, a certificate from the treasurer that the stock is fully paid, a copy of the form of stock certificate issued, a record of the vote of the directors approving this form and the votes appointing the transfer agent and the registrar, a certified list of the officers and directors of the corporation and their signatures, etc.

The Stock Books and Transfer of Certificates

The transfer department is the custodian of the stock books of the corporations for which it acts as transfer agent. These include the stock certificate book, the transfer book, and the stock ledger. The certificates are numbered consecutively, are signed by the proper officers of the corporation before delivery to the transfer agent, and are not issued unless countersigned by the transfer agent. The transfer agent passes upon the regularity

and legality of the assignment of title to the certificate, enters the transaction in the transfer book, cancels the old certificate, and executes and delivers the new certificate.

On the back of the certificate is a blank which provides for the transfer of the stock upon sale, by constituting the new owner an attorney for the purpose of transfer. The common form of this assignment of the stock and irrevocable power of attorney is:

> For value received .... hereby sell, assign and transfer unto .... the shares of capital stock represented by the within certificate, and do hereby irrevocably constitute and appoint .... attorney to transfer the said stock on the books of the within-named company, with full power of substitution in the premises.
>
> Dated .... Signed ... .
>
> In the presence of ....

The buyer will ultimately have the stock transferred to his own name, but meanwhile he has an evidence of ownership. Dividends are paid to the persons who are registered holders on the books of the company; as soon as the books are closed, by reason of the annual meeting of the stockholders, declaration of dividend, or other cause, all transactions in these stocks are "ex-dividend." To "close the books" means to cease making transfers and to prepare a list of the stockholders of record at the time of closing. The purpose is to send out notices of the meeting and proxies and to give the company an opportunity to prepare dividend checks and not have to work on transfers at the same time. The period of closing may be as much as three weeks, and meanwhile the certificates will be passing from trader to trader as "bearer" certificates.

The hours for receiving stocks for transfer are, by rule of the New York Stock Exchange, from 10 A.M. to 2:15 P.M., except at such times as the transfer books are closed for a dividend or for the annual meeting, when the hours are extended to 3 o'clock.

Procedure in Transfer of Certificates

When a certificate is presented for transfer, it is carefully examined to see that it is signed by the duly authorized officers of the company and by the transfer agent and the registrar. It is also examined for dates, fillings, and perforation on fractional certificates. It is also important to see that there is no stop-transfer lodged against the certificate and that the proper amount of state and federal tax stamps is attached.

The assignment on the reverse side of the certificate must correspond exactly with the inscription on the certificate. The date of the assignment must be either that of the day when it was drawn or a subsequent date. When a certificate is to be transferred, the owner signs the irrevocable power of attorney, and the signature is witnessed and guaranteed by a member of the stock exchange, or by a bank with a correspondent in the same city, or, if this is not convenient, by a notary public whose authority is shown by an attached certificate from the county clerk. If the transfer agent knows the owner's signature, this guaranty may not be insisted upon.

The transfer department has on file cards showing specimen signatures of members of the firms who are members of the leading stock exchanges. These cards bear the following notation: "The persons whose signatures appear on this card are authorized to sign and indorse for this firm for any and all purposes in connection with the transfers of stocks and bonds until a written notice of revocation has been filed with you."

The owner having signed the assignment and power of attorney, in order to complete the transfer it is necessary only to fill in the name of the transferee. In general this is left blank and the certificate is in "bearer" form, that is, it is ready for transfer at any time and can pass from one owner to another by mere delivery, until some purchaser decides to have it transferred on the books of the company. If by chance the name of the attorney has been filled in and it is not desired to transfer the

shares, a "power of substitution" is executed on the back of the certificate, which reads: "I hereby irrevocably constitute and appoint .... my substitute to transfer the within named stock under the foregoing Power of Attorney, with like Power of Substitution. Dated.......... Signed............ In presence of................." The certificate is then again transferable by delivery.

The owner of a certificate has the right to request a stop-transfer in the case of loss or theft of the certificate or other contingency. The transfer may also be estopped by order of court. To transfer contrary to a stop-payment order makes the transfer agent liable, and so the windowman keeps a sheet or card file of these orders before him at all times. Upon notification by a stockholder that his certificate has been lost, stolen, or destroyed, a "stop" is immediately placed against the certificate number in the ledger and the name, amount of shares, and certificate number are entered on the "stop-transfer" list, and the registrar and the other transfer agents of the corporation are advised of the stop-transfer. A new certificate is not usually issued until one year after the notice of loss, and then only after the filing by the owner of a bond of indemnity for two or more times the par value of the stock.

Transfers in Fiduciary Capacities

Since most transfers result from stock exchange sales, the rules of the exchange for "good delivery" must be observed. Securities in the name of individuals in fiduciary capacities are not "good deliveries," and when the word "executor," "administrator," "trustee," "guardian," or the like appears on the certificate the transfer agent is put on guard to see that the instrument or authority creating the trust gives the power of sale.

1. *Transfers by Executors.* When a certificate is transferred from the estate of a decedent testate, the transfer agent requires a copy of the last will and testament of the deceased, a recent

probate court certificate showing the appointment of the executor, and a waiver of inheritance tax from the state of incorporation and from the state in which the transfer is made. Also, in the event of the stock going to the executor as an individual, he must file an affidavit stating that there are no debts and claims outstanding, and should there be such debts or claims, ample provision must be made therefor.

2. *Transfers by Administrators.* When a certificate of stock is transferred from the estate of a decedent intestate, the transfer agent requires a certificate of the granting of letters of administration, the same waiver as in the case of the decedent testate, and, if the transfer is made to the administrator as an individual, an affidavit as above described of the kind required in the case of an executor, or an order from the court authorizing the administrator to make the transfer. The procedure is governed by the laws of the state of which the deceased was a resident. Only one signature to the assignment of an executor or administrator is required.

3. *Transfers by Trustees.* In a transfer of this kind there must be a certified copy of the court appointment, if any; a copy of the instrument under which the trustee acts; and, if the stock is transferred to the trustee as an individual, an affidavit or court order of the kind above mentioned. It is necessary that all trustees execute the assignments, the signature of one alone not being sufficient.

4. *Transfers by Guardians.* In transfers by guardians, a certificate of the court appointment is required, and in the event of the stock going to the ward, a statement is filed signed by the guardian to the effect that the ward has become of age. When a father acts as guardian without having been formally appointed by the court, a signed statement by him to that effect is necessary.

5. *Transfers by Corporations and Associations.* In such cases there must be furnished a certified copy of the by-laws of the corporation, a certificate of incorporation, and a resolution from the

board of directors authorizing the transfer and naming the officer to make the transfer.

The Delivery of the New Certificates

When the windowman of the transfer department is satisfied that the certificate is a "good transfer," that is, that it conforms to the requirements of law and of the stock exchange, the person presenting it is asked to fill in the name of the transferee. If the transfer is to be made to an individual, his full name and address should be given; if to a married woman, her own name should be entered and not that of her husband, for example, "Mary Smith" and not "Mrs. John Smith"; if to an estate, it must read "John Doe, Executor of the Estate of Richard Roe"; and if to trustees, a brief description of the trust must be given. After the certificate is properly filled in, the windowman gives the person presenting it a numbered blank receipt, the numbered stub of which is attached to the certificate.

The certificate is next entered on the bank's transfer sheets. These are ruled with a date column, a debit or certificate-surrendered column, and a credit or certificate-issued column. On the debit side entry is made of the name of the former stockholder, the number of the certificate, and the amount of shares; and on the credit side the name and address of the new stockholder, the number of the new certificate, and the amount of shares. A duplicate sheet is made and forwarded to the respective agents in the states under which the companies are incorporated. The number and amount of the new stock are then put on the stub and the certificate is detached from the stub. The amount of the new stock must agree with the canceled stock and must prove with the balance of credits at the beginning of business and the credit at the close of business. The new stock is handed to the proper bank officer for signature, as transfer agent, and the canceled stock to some other department for proving against the new stock.

Upon completion, the stock is returned to the transfer department of the bank and by it delivered to the office of the registrar. After registration, it is sent back again to the bank and is examined by the transfer department for the registrar's signature and for the date, and when ready for delivery, say, about 1:30 P.M., it is pinned to the stub of the receipt. The name of the transfer clerk is entered in the power of attorney on the back of the old certificates and they are filed away in numerical order.

The Stock Ledgers

The posting from the stock ledgers is made from the transfer sheets on the following morning. It is important that these postings be made before 1:30 P.M., so as to be able to detect any raised certificates and to prevent the overlooking of stop-transfers. The ledger sheets are provided with a space at the top for the name of the stockholder and his address and the name of the person to whom he desires his dividends to be sent. They are ruled with a debit and a credit side; on the debit side are the date of surrender, the number of the certificate, and the amount of shares, and on the credit side are the date of issue, the number of the certificate, the date of cancellation, the number of shares, and the balance. As a means of checking the entries, the sheets may be entered in alphabetical order and a record kept of the stock standing under each letter of the alphabet; upon the completion of a set of such sheets, the debits and credits of the different letters may then be footed and entered in a proof book and the total credits of each letter proved against the amount of stock outstanding.

When a corporation for which the bank is transfer agent declares a dividend, the department is notified by the secretary of the corporation, with advice of the rate, date of record, and the date when payable. Dividend sheets are prepared with a list of the stockholders and their addresses, and these are

footed, proved against the proof book, and delivered to the corporation.

Some corporations whose stocks are listed on exchanges in other cities maintain several transfer agents, and the certificates are transferable at each agency. In such case, in making a transfer the transfer agent assumes full responsibility and notifies the other agent or agents of the name of the stockholder, the amount of shares, and the certificate number, and forwards to him the canceled certificates. If stock ledgers are kept in each city, the transfer agents are required to report daily to each other the number of shares canceled in a city other than that in which the shares were issued; but if the stock ledger is kept only in one headquarters city, the transfer agents are required to report only to that city.

Taxation of Transfers

Some of the states impose transfer taxes. The state of New York, for instance, imposes a tax on all sales, agreements to sell, or memoranda of sales of stock, and upon any and all deliveries or transfers of shares or certificates of stock, at the rate of 2 cents on each $100 of par value or fraction thereof. The federal government imposed a similar tax of 2 cents per $100 or fraction thereof, beginning December 1, 1917. These taxes must be paid before the transfer can be made. The payment is noted by stamps affixed to the surrendered certificate or to attached bill of sale. Every stamp must be canceled by writing or by stamping the initials of either the maker of the instrument or of the person actually affixing the stamp. The transfer agent is obliged to see that every stamp is properly affixed on the certificate or bill of sale and that it is duly canceled. The seller pays the transfer tax; if he lives, say, in Massachusetts and the transfer is made in New York, he will have to pay the Massachusetts state tax, the New York state tax, and the federal tax; but the transfer agent in such case has only the latter two taxes to care for.

Proxies

The transfer department may act as transfer agent for the bank itself. If it does so act, about a month before the annual meeting of the stockholders takes place there is mailed to each stockholder a proxy with a letter attached informing him of the date of the meeting and requesting him to sign the proxy and return it to the department if he cannot be present. These returned signed proxies are sorted according to the ledger, and the number of shares is entered at the top of each proxy. The proxy list has columns for the stockholder's name, the amount of shares, and the amount of proxies. On the day of the annual meeting these proxies are handed to the officers of the bank.

Subscriptions to Capital Stock

The transfer department also receives subscriptions for the increase of capital stock of the corporations for which the bank acts as transfer agent. In most cases the subscriptions are payable in instalments, and where payments are made they are noted on the back of instalment receipts which are issued to subscribers. A record is kept in a ledger showing the amount paid in for each account, also the total amount received each day. The aggregate amount of cash and checks received each day is proved against the subscription receipts and credited to the account on the individual ledger. The amount of detail work connected with some subscriptions is very great. In case shares are issued before they are fully paid, the certificate states that such and such instalments have been paid and the later payments are indorsed on the back.

Compensation of Transfer Agent

The system of compensation by a corporation to its transfer agent or registrar varies greatly. Sometimes the contract drawn is for the purpose of paying a certain amount for each certificate registered and for each one transferred. The most common

arrangement is a yearly contract by which for a fixed aggregate sum the transfer agent agrees to do the transfer work irrespective of the number of certificates presented, but with special fees for making a transfer and getting out the new certificate the same day and for each additional certificate issued in the same name, that is, when a holder of, say, a 100-share certificate asks for two 50-share or ten 10-share certificates in exchange. The corporation bears the expense of engraving and providing new certificates. The total earnings are much increased where the unit of trading on the stock exchange is small, say, 10-share lots as compared with 100-share lots. When certificates are sent to London they are first broken into 10-share certificates, for the unit of trading in London is 10 shares.

The sum charged, other than the extra fees just mentioned, for the year's services varies with the volume of the work, which in turn depends upon the following factors: the number and kinds of services undertaken, the number of shares and of stockholders, the activity of the shares, the frequency of dividends and whether the bank sends out the dividend checks, whether the corporation is a customer of the bank, etc. But whatever the amount agreed upon, it covers all services, postage, envelopes, etc. The transfer agent assumes greater responsibilities than does the registrar and his compensation is accordingly larger.

The Nature of a Paying or Fiscal Agency

The large metropolitan banks and trust companies act as paying or fiscal agents for corporations, municipalities, etc. A paying agent is most useful if located in New York City, the money center of the country; but convenience is also served by having fiscal agents in several cities. The state in which the corporation is chartered usually requires that a paying agency be maintained inside the state; and the stock exchanges, at the time of listing the securities of a corporation, sometimes insist that it maintain a paying agent in their respective cities.

The terms and conditions under which the bank undertakes to act as paying agent are various. In many instances, the money needed for the redemption and payment of bonds and interest coupons is deposited with the bank and a special account is opened against which only maturing bonds and coupons are charged. In all other cases the bank is authorized to charge the account of a correspondent; the signatures to all such instructions are closely verified and a record of the bank's balance is obtained.

The usual arrangement is for the bank to act on a commission basis. Sometimes, however, in case of big corporations and large payments, the bank accepts in lieu of a commission a deposit of the money needed to pay the maturing bonds or coupons, say, fifteen days before maturity, and the use of these funds is assumed to equal the regular commission charge. The commission and other terms are matters of contract between principal and agent.

When requested to handle a new issue, the bank requires a specimen bond or a detailed description of it, together with specimens of the signatures appearing on the bond. If the issue is that of a corporation, it is necessary to know whether or not the bonds contain a provision to pay the interest in full, regardless of any federal or state tax which may be imposed. Interest on bonds with such a tax-free covenant clause, paid to citizens and residents of the United States (individuals and fiduciaries) not claiming personal exemption, to domestic and resident partnerships, to non-resident alien individuals or fiduciaries, to foreign partnerships, and to foreign corporations having no office or place of business in the United States, or in case the owner is unknown, is subject to the normal income tax of 2 per cent, required to be withheld and paid at the source. Interest on bonds without the tax-free covenant clause, (1) if paid to a non-resident alien individual, or in case the owner is unknown, is subject to a normal tax of 8 per cent, required to be withheld and paid at the

source, and (2) if paid to a foreign corporation having no office or place of business in the United States, is subject to a normal tax of 10 per cent, required to be withheld and paid at the source. Interest on bonds with the tax-free covenant clause, paid to citizens and residents of the United States claiming personal exemption, is paid in full.

Many corporations for which the bank acts as paying agent appoint the bank to make returns of the income tax to the government. Some of them deposit with the bank additional funds to cover the normal tax on the interest paid on their bonds. The other companies who pay the tax on their bonds agree to have the bank charge their account for any tax which it is required to remit to the government. When the company elects to make its own returns, the bank demands a letter of indemnity guaranteeing it against any claim which the government may make against the bank as paying agent.

Method of Handling the Coupons

To facilitate the work of paying coupons they are divided into classes according to distinctions made necessary by the regulations of the United States Treasury relating to the federal income tax. Coupons on bonds of the United States government, state and city governments, and on subdivisions thereof, are free from the normal tax, but the bonds of domestic and foreign corporations and foreign countries are subject to that tax. Some corporate bonds contain the tax-free covenant, and some are owned by non-resident alien individuals or foreign corporations.

The Commissioner of Internal Revenue requires owners of bonds to file with the coupons from each issue of bonds (except municipals) a certificate of ownership stating whether or not they are exempt from the normal tax at the source. As an aid to the classification of these certificates by the paying agents, those claiming exemption are printed on yellow paper, those not claiming exemption on white paper, and those of foreign securities on

green paper. The person or corporation first receiving coupons for collection must place his or its name and address, together with the date of collection, on the back of the certificate. The collecting agent is permitted to issue substitute certificates for the originals.

The department employs the following books in its work: the coupon check book, the coupon return book, and the coupon ledger. A card index serves as a ready reference file and contains all needed information about the different issues which the department pays.

When bonds and coupons are presented for payment, they are examined for genuineness, maturity, stop-payments, and calls. They are then counted and the following entries are made in the check book: date, number of check, title of bonds, to whom paid, number of bonds or coupons, net amount paid; and when taxable, the name and address of the owner, and the amount, less the income tax, are included.

The checks are drawn for the net amount, to be paid to each presenter in accordance with these entries.

The coupons are then recounted and canceled. After banking hours they are sorted and each kind is entered on a separate list, from which a ticket is made out, debiting the account to be charged and crediting the coupon account against which the checks have been drawn. The amount of the tax withheld during the day is then credited to the federal income tax account.

Entries are first made in the coupon ledger, showing the amount of coupons paid for each account and then in the return book; the total of this book must prove against the amount of checks issued.

At the end of each month the coupon accounts are ruled off and the balances compared with those on the ledger. At this time the certificates of ownership, detached from the coupons of the different corporations which have designated the bank as withholding agent to make return of the tax to the government, are

divided into groups preparatory to making the monthly reports required by the United States Internal Revenue Service on or before the twentieth of each month succeeding that during which the coupons are paid. One of these reports covers the payments of interest on bonds and other similar obligations of domestic and resident corporations and foreign corporations having a paying agent in the United States, which contain a tax-free covenant clause providing for payment of the normal income tax at the source. The three classes of this type are described in the preceding section. This report lists alphabetically the names of the payees, with their addresses and the amount of interest paid to and tax withheld from each. Of these monthly reports an annual summary, giving totals by months and classes of payees, is prepared and on or before March 1 is, like the monthly reports, sent to the Collector of Internal Revenue for the district in which the withholding agent is located.

A monthly information return with respect to payments of interest of domestic and resident corporations, foreign corporations and countries, and dividends on stock of foreign corporations, is required to be sent to the Commissioner of Internal Revenue at Washington on or before the twentieth of the month succeeding that for which it is made. This covers payments on which the tax is not withheld and paid at the source. The proper ownership certificates must accompany this monthly report, and an annual return summarizing the monthly reports is required on or before March 15 of the following year.

The Trust Department—Legal Requirements

In order to put national banks more nearly on the same competitive plane as state banks and trust companies, the Federal Reserve Act authorized the Federal Reserve Board to grant by special permit to national banks applying therefor, when not in contravention of state or local law, the right to act as trustee, executor, administrator, or registrar of stocks and bonds, under

such rules and regulations as the board may prescribe. Such application is made by the national bank through the chairman of the board of directors of the federal reserve bank of that district, who transmits it to the Federal Reserve Board with his recommendations. The board reserves the right to revoke any such permits where in its opinion the bank has wilfully violated its regulations or the laws of the state relating to such trust operations.

A national bank permitted to perform the trust functions is required to establish a separate trust department under the management of an officer or officers, whose duties must be prescribed by the board of directors of the bank. The funds, securities, and investments held in each trust must be held separate and distinct from the general funds and securities of the bank and separate and distinct from one another. They must be placed in the joint custody of two or more officers or other employees designated by the board of directors, and all such officers or employees must be put under bond. The ledgers and other books kept for the trust department must be entirely separate and apart from the other books and records of the bank.

This department is subject to examination by the examiners appointed by the Comptroller of the Currency or designated by the Federal Reserve Board, at the same time as the examination is made of the other departments of the bank. It is also subject to inspection by the state authorities to the degree that the state banks and trust companies are subject to an inspection of their trust business.

No national bank has, with respect to trust business, any rights or privileges in contravention of the laws of the state in which the bank is located. On the other hand, it enjoys without discrimination any rights or privileges conferred by the state upon the state banks and trust companies competing with it.

No national bank may receive in its trust department deposits of current funds subject to check or the deposit of checks, drafts, bills of exchange, or other items for collection or exchange

purposes. Funds deposited or held in trust by the bank awaiting investment must be carried in a separate account and not be used by the bank in the conduct of its business, unless it first sets aside in the trust department United States bonds or other securities approved by the Federal Reserve Board.

Funds held in trust must be invested in strict accordance with the terms of the will, deed, or other instrument creating the trust. Where the instrument creating the trust contains provisions authorizing the bank, its officers, or its directors to exercise their discretion in the matter of investments, funds held in trust may be invested only in those classes of securities which are approved by the directors of the bank. Where the instrument creating the trust does not specify the character or class of investments to be made and does not expressly vest in the bank, its officers, or its directors a discretion in the matter of investments, funds held in trust must be invested in any securities in which corporate or individual fiduciaries in the state in which the bank is located may lawfully invest.

Except as provided otherwise, a national bank acting as executor, administrator, or in any other fiduciary capacity, under appointment by a court of competent jurisdiction, must make all investments under an order of that court, and copies of all such orders must be filed and preserved with the records of the trust department. If the court by general order vests a discretion in the national bank to invest funds held in trust, or if under the laws of the state in which the bank is located corporate fiduciaries appointed by the court are permitted to exercise such discretion, the national bank so appointed may invest such funds in any securities in which corporate or individual fiduciaries in the state in which the bank is located may lawfully invest.

Development of a Trust Department

The trust department is not a bank within a bank. It should, however, be located by itself, much as the savings department is,

accessible to the public, and the officers and clerical force should not be far removed from each other.

The most important action in the establishment of a trust department is the selection of the trust officer. He should be a man of the very highest moral integrity, and especially fitted by temperament, expert knowledge, and long training in fiduciary business. His duties are multifarious. He should be a lawyer, and a very "versatile one, for there come before him every form of business complication and every phase of human character, good and bad. There is no problem, legal or otherwise, which our complex civilization brings forth, which he may not be called upon to solve." In most respects trust business differs from commercial banking—in principles, technical procedure, legal and personal relationships with customers, and so forth; hence not every successful commercial banker makes a successful trust officer. It is unwise and dangerous to have but one trust officer; there should be two or more entirely familiar with the work and jointly responsible.

The development of a trust department is a slow process. Ordinarily it takes five years at least to put it on a fixed and paying basis. No bank should establish one unless it is determined to give it a fair trial and to finance it for a number of years. It is practically impossible for a corporate executor to discontinue the trust relation after it has once been assumed. In states where the law requires a deposit by the bank which would act in a trust capacity without bond, the sum so deposited can rarely be removed. The ramifications of the trust business are such that a termination of all of it is impracticable. A good way to start is for the directors and officers of the bank itself to lodge their wills with the department. This not only gives initial business, but also gives the public confidence in the bank's new department. Banks in cities and county seats will be more likely to succeed in the trust business than those in smaller places.

In determining the advisability of establishing a trust depart-

ment, the arguments that fiduciary business should not be undertaken, because it involves the bank in grave responsibilities which it is inadequately equipped to perform, because it means a net cost for a number of years at least, because the possible volume of business is too small to make it worth while, and because it will result in the hostility of the local lawyers who regard the new activity as an intrusion into their own particular province, are balanced against the arguments that trust business once built up will provide steady and dependable earnings, that through this service the bank will be able to retain customers who otherwise will be attracted to the institution handling their fiduciary business, and that the new and intimate relationships with customers will afford an avenue for new business for the other departments of the bank.

In accepting trust business the department should be selective. Business for which the compensation is inadequate should not be accepted unless it will surely lead to other profitable business. Business in which bitterness and family enmities are known to exist or may be expected may cost the bank more in loss of patronage and good-will than it brings dollars. If the bank is a joint trustee with an individual or individuals, it, as a corporate trustee, should ask more compensation than the individual trustee, for its responsibilities and work will be greater.

A national bank is qualified to act as trustee. It is a corporate fiduciary and preferable to an individual fiduciary because it offers greater financial responsibility, continued or perpetual existence, financial judgment, accumulated experience, expert officers and employees, and impartial execution of its business. Its charter is almost automatically renewed under the law. Its settlers of trust and its creditors are protected by the double liability of its stockholders.

As yet no scale of charges for trust work has been adopted by the national banks operating trust departments. It is desirable that some uniform or standard method of charging be adopted,

and that the cutting of rates for competitive advantage be minimized. It may be well for the departments to charge according to the "Schedule of Trust Company Charges," compiled by the Committee on Standardization of Forms and Charges, Trust Company Section, American Bankers' Association, and adopted by that section on September 29, 1919.

Up to June 30, 1920, the Federal Reserve Board had issued 1,227 permits to national banks to perform trust company functions. Since there are less than 2,300 trust companies in the United States, this represents an increase of more than 50 per cent in the institutions that handle fiduciary business. Moreover some states also have authorized their state banks to undertake this new line of activity. The distribution of the national banks which have permission to execute trusts is indicated by the following table:

Federal Reserve District		Leading States	
No. 1	126	New York	119
No. 2	170	Pennsylvania	115
No. 3	110	Indiana	71
No. 4	91	Massachusetts	66
No. 5	74	Iowa	62
No. 6	60	New Jersey	58
No. 7	193	Illinois	56
No. 8	80	Ohio	52
No. 9	60	Texas	48
No. 10	129		
No. 11	58		
No. 12	76		

The Savings Department

There is nothing in the National Bank Act or the Federal Reserve Act authorizing the operation of a savings department, and as the capital, deposits, and all other funds of a national bank may be loaned or otherwise invested only in conformity with the provisions of law, it follows that the sole business of a savings

bank which can be legally transacted by a national bank is the paying of interest on deposits.

The counsel of the Federal Reserve Board has rendered an opinion that the federal law relating to the establishment and operation of national banks is superior to and controlling over a state law which might otherwise apply to or govern the operation of national banks. Congress having conferred on national banks the power to pay interest on time deposits, it is evident that the right to advertise and solicit such savings accounts is a necessary incident to the exercise of that power, and that no state law can interfere with its exercise.

The amended Federal Reserve Act provides that the reserve against time deposits shall be 3 per cent. Time deposits include, among other items, all savings accounts and certificates of deposit which are subject to not less than 30 days' notice before payment. This low reserve requirement makes savings accounts more profitable to the bank or makes it possible to pay higher rates of interest on deposits. The Federal Reserve Board in its early interpretation of the Federal Reserve Act took the position that the broad provisions of the law respecting time deposits, savings accounts, and certificates of deposits should not be made the means of any large reduction of reserves by a transfer to those *forms* of deposits which are in *substance* demand deposits; it insisted that the full reserve, at the rate prescribed for demand deposits, be carried against all savings accounts and all time deposits whether on open account or certificate, which are subject to check or which the bank has been notified are to be withdrawn within 30 days.

"Time deposits, open accounts" are defined to include all accounts, not evidenced by certificates of deposit or savings passbooks, in respect to which a written contract is entered into with the depositor at the time the deposit is made, that neither the whole nor any part of such deposit may be withdrawn by check or otherwise except on a given date or on written notice given by

the depositor a certain specified number of days in advance, in no case less than 30 days.

Savings accounts include those accounts of the bank in respect to which, by its printed regulations, accepted by the depositor at the time the account is opened, (1) the pass-book, certificate, or other similiar form of receipt must be presented to the bank whenever a deposit or withdrawal is made, and (2) the depositor may at any time be required by the bank to give notice of an intended withdrawal not less than 30 days before a withdrawal is made.

A time certificate of deposit is an instrument evidencing the deposit with a bank, either with or without interest, of a certain sum specified on the face of the certificate, payable in whole or part to the depositor or on his order: (1) on a certain date, specified on the certificate, not less than 30 days after the date of the deposit, or (2) after the lapse of a certain specified time subsequent to the date of the certificate, in no case less than 30 days, or (3) upon written notice given a certain specified number of days, not less that 30, before the date of repayment, and (4) in all cases only upon presentation of the certificate at each withdrawal for proper indorsement or surrender.

The rate of interest paid on savings and time deposits depends upon the intensity of competition among the banks of the locality and upon the condition of the money market. Whether the banks will insist upon having 30 days' notice depends also upon the intensity of competition, upon the amount demanded, upon the condition of the bank at the time of the demand, and upon the customer. Whether the bank will compound the interest quarterly, semiannually, or annually, and whether a deposit begins to draw interest immediately, or at the end of 30 days, or at the beginning of the next quarter, are likewise determined by competition.[1]

[1] For a good set of rules and regulations suggested for the conduct of a savings department, see the *Bankers' Magazine* (New York), Vol. 90, pp. 589-590.

Before the Federal Reserve Act was passed, the savings department in national banks existed only by sufferance of the Comptroller of the Currency, the National Bank Law giving no explicit sanction for it. Although practically all banks have long issued certificates of deposit for dormant money, the savings department as such, issuing pass-books and operating along savings bank lines, is a recent development. It is now customary for banks to establish a savings department more or less separate from the rest of the bank. The methods of business are so different that this is found expedient. A well-placarded and advertised savings department is a good avenue of business for the other departments of the bank. Special inducements, Christmas clubs, vacation clubs, partial-payment bond purchases, savings boxes, dime savings, etc., are used to attract customers, many of whom become permanent patrons of the bank in other lines.

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